THE NEW YORK

Certified Public Accountant

THE STATE SOCIETY'S 60TH YEAR

VOL. XXVII *March* • *1957* No. 3

Society and Editorial Offices: 677 Fifth Avenue, New York 22, N. Y.

Accounting News And Trends

Open Sesame

The combination that will open the "bankers' vaults" for loans to the businessman is an unqualified audit report by an independent CPA. This thought is expressed in the intriguing introduction to a thought-provoking article by Arthur L. Nash, Vice-President, Brown Brothers Harriman & Co., in the *Robert Morris Associates Bulletin* (December, 1956). The article is entitled *A Combination Which Will Open Almost Any Vault.*

The article discusses such matters as:

1. The need for a greater comprehension by CPAs of the broad requirements of bankers for adequate statements for credit purposes and the need for greater understanding by bankers of CPA auditing standards and procedures.
2. The lack of full disclosure of material facts in some financial statements accompanying CPA audit reports.
3. The difficulty which bankers experience in obtaining adequate information as to the competency of a CPA firm unknown to the bank.
4. The need for additional accounting services to clients which will aid them in their business and help the bankers decide on a sound basis for credit.

The author recognizes that the CPA's scope of examination is determined by the nature of his engagement as authorized by the client and points out that more and more bankers are insisting on an unqualified opinion before they will grant credit.

As a banker, Mr. Nash is frank to concede that some bankers have been quite hesitant to "beard the lion in his den" and tell the borrower that his financial reports are deficient. Indeed, in many cases, the banker blames the accountant for such deficiencies even though a careful reading of the certificate would reveal that limitations in the scope of the examination had been fully disclosed.

Depreciation on Replacement Cost

Replacement cost depreciation has been the subject of renewed comments in the last few months by leaders in accounting on both sides of the Atlantic. Sir John Braithwaite, Chairman of the London Stock Exchange, made a public appeal to the Chancellor of the Exchequer to adopt what he termed a realistic basis for determining depreciation. He pointed out that company profits as published and taxed are artificially inflated so long as depreciation allowances are permitted for taxation purposes only on the historical cost basis. He conceded that there would be difficulties in computation when taxation enters the debatable realm of indices and estimates but expressed confidence that tax men could work out an acceptable basis for calculating depreciation.

Somewhat the same thoughts are expressed by Mark Richardson and Leslie Mills in their recent addresses before the National Industrial Conference Board. They suggest that there may be very sound economic reasons for allowing a tax provision for depreciation to be based on replacement cost even if such provision would not be appropriate for customary financial reporting purposes because of its departure from generally accepted accounting principles.

Internal Control and Legal Responsibility

In a provocative article entitled *Internal Control and Legal Responsibility* (*Journal of Accountancy*, February, 1957), Saul Levy outlines areas of danger and makes certain suggestions. He points out that the accountant's review of internal control is in no sense a management survey but is necessary in planning the audit program. This program, in turn, enables the accountant to express an opinion on financial position and operating results. An accountant, therefore, should limit his examination to those aspects of internal control that directly relate to accounting records.

At present many accounting firms do not so limit themselves, but delve into those

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Accounting News and Trends *is conducted by* Charles L. Savage, C.P.A. *and member of the New York Bar. He is presently serving on the Board of Directors of the Nassau-Suffolk Chapter of our Society.*

Dr. Savage is professor of accounting and chairman of the Business Administration Department of Adelphi College.

aspects of internal control which do not directly concern the accounting records. Specifically, such non-financial items as training programs, time and motion studies, and cost controls, are related to a "system" of internal control in a "Special Report on Internal Control" prepared by a Committee of the AIA in 1948. From the standpoint of legal responsibility there is an obvious danger of assuming such broad responsibility with respect to a review of internal control and the author urges accountants to limit themselves to financial controls.

Mr. Levy also warns the accountant not to be too dramatic in informing management about weaknesses in internal control. The systems men who often prepare these letters are naturally eager to galvanize clients into action, and indicate clearly how easy it would be to pad the payroll or cover up an embezzlement. In a later court case, the average juror, hearing these words out of context, might conclude that if the circumstances were really so bad, the accountant was not justified in rendering an unqualified opinion.

Accounting for Returnable Containers

The N.A.C.A. Accounting Practice Report No. 4 is a 31-page discussion on *Accounting for Returnable Containers.* It classifies and summarizes the practices of some 83 companies. Among other items considered are variations in methods of: recording deposits and the investment in containers; providing for depreciation; recognizing losses from non-return; controlling the shipment and receipt of containers; controlling the containers while in the customers' plants.

Specific illustrations of some of the variations in accounting and reporting treatment of returnable containers are:

1. Containers have been classified in some cases as fixed assets and in others as inventory and reflected in the current section. In several cases the current classification was adhered to despite the fact that depreciation was charged, and, in most cases, the inventory had a useful life extending beyond the 12-month period.

2. Returnable Containers have been viewed as a receivable (where no deposit was received), as a lease (with the deposit treated as a security), or as a sale. The booklet indicates that although technical title may not have actually passed to the customer, the transfer was regarded as a sale and accounted for as such because of a desire to simplify the accounting and to treat it in the same manner as was done for tax purposes.

This helpful booklet can be obtained from the N.A.C.A., 505 Park Avenue, New York 22, New York.

Inter-American Accounting Conference

The fourth Inter-American Conference will be held in Santiago, Chile, from November 15 to 23, 1957. The AIA reports that some of the objectives are to develop standard accounting terminology and common policies.

Municipal Accounting

Those accountants doing municipal audits might find helpful a bulletin entitled *Minimum Requirements For Municipal Audit Reports Involving Revenue Bonds.* This bulletin urges the observance of minimum audit coverage and report requirements in all cases where local governmental agencies have outstanding Revenue Bonds. Of particular interest is a list of common accounting errors made in connection with municipal audits, of which the following are illustrative.

One is the failure to call attention to the omission or improper accumulation of a reserve fund as prescribed in the indenture. Another is the improper classification of depreciation and bond interest which, it is stated, should appear in the operating statement following the caption, "Net Revenue" or "Balance Available For Debt Service."

The Texas Society of CPAs cooperated in the preparation of this bulletin and copies can be obtained from the Municipal Advisory Council of Texas, Plymouth Life Building, Austin, Texas.

Suggested Library for Accountants

A new listing of 150 accounting books for practitioners wishing to build up a basic accounting library, is now available from the AIA library. This is an up-to-date revision of a list issued last year. The approximate cost of all the books suggested is $1,200.

Recognition Certificate

The Colorado Springs Chapter of the Colorado Society of CPAs has done some pioneering work in public relations which has elicited favorable comments. This Chapter makes an award of a "Recognition Certificate" to individuals who demonstrate their loyalty and interest in public accounting. Their most recent award was to a local revenue agent.

Letters to the Editor

Designation of Code Numbers on New York State Franchise Tax Reports

Due to the combined cooperative efforts of Tax Commissioner, George M. Bragalini, and Deputy Tax Commissioner, Harold J. Connors, the Franchise Tax Forms 3 CT are being issued to C.P.A. practitioners in bulk this year from February 1st on. This will make it possible, for the first time in many years, for practitioners to prepare their Federal Corporation Income Tax returns and their New York State Franchise Tax reports simultaneously.

One word of caution, however, must be given. The code number of each corporate taxpayer must appear on the copy of the form filed. Early issuance of the returns, in bulk this year, is in the nature of an experiment with the Tax Commission. If code numbers are not inserted on the forms filed, the forms will not again be issued in bulk, and practitioners will have to wait until the stenciled forms, which contain the name, address, and code numbers, are issued, perhaps a month or more later.

Practitioners who use reproduction machines for the preparation of their tax returns have, as a result of the early issuance of the forms, been receiving their blanks since early in February. They too, must be specially cautioned about the insertion of file numbers on the forms, or they will be similarly handicapped next year by a much delayed issuance date for their blanks.

Miriam I. R. Eolis, CPA
Chairman, Committee on
State Taxation

Need for CPA Pension Plan

Much has been written about the preparation of persons for entrance into the accounting profession. But to this writer it is becoming increasingly evident that in attempting to attract promising applicants, the small or average size accounting firms are finding themselves at a disadvantage. The reason is obvious. Today everyone is concerned with economic security. Corporations offer all sorts of fringe benefits including life insurance, medical attention, retirement pay, etc., etc., with which the small accounting firm is unable to compete. Again, if the accounting firm dissolves or merges, some members of the staff may not be required, and if he or she has reached what is now considered the ripe old age of 40, the problem of obtaining employment is a serious one.

The time may now be opportune to reiterate some of the thoughts I expressed in my article which appeared in the February 1949 issue of *The New York Certified Public Accountant* under the title "The Old Order Changeth":

"Those who contemplate entrance into the field of public accounting, presently and in the future, must be assured of something beyond immediate positions and the slim possibility of a future partnership interest. And it is here that the profession can take a leaf out of industry's book and establish pension and other welfare plans. Because public accounting is carried on by partnerships and sole practitioners, the matter of pension plans would have to be developed, it would seem, on a profession-wide basis. Thus, a staff member moving from one employing accountant to another would be covered at all times, somewhat in the manner that teachers are protected. A committee composed of members of the leading accounting societies could endeavor to interest one of the long established insurance companies in this matter. A plan could be devised whereby the employing accountants and the staff members would contribute to the over-all pension fund as required by the insurance company."

Thomas W. Byrnes, CPA
New York, N. Y.

The Disclaimer and Undue Responsibilities

In the December 1956 issue of the *New York Certified Public Accountant,* Stephen Chan raises the question of the accountant's responsibility in revealing the failure of a client to carry out proper accounting principles as for example, in valuation of inventories, where the accountant has used a disclaimer of opinion regarding this asset because of not being able to verify its physical

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presence. In the January 1957 issue, Eugene Rosenfeld ably expressed the accountant's responsibility to third parties and the revealing of any vital information regardless of the use of the disclaimer.

Now it is not my intention to disavow responsibility to third parties, but to merely point out that there is an inherent danger in the accountant assuming responsibility for an asset valuation where he has already expressed a disclaimer regarding same. By his disclaimer, the accountant has unequivocally put third parties on notice that if they desire his opinion, further auditing steps will be required. Banks and credit managers have aided the accountant in educating clients as to the need for thorough auditing procedures, by insisting on an accountant's opinion in regards to the debtor's financial statement. To assume responsibility where such thorough procedures were not carried out is, I believe, taking a step backward.

Dangerous precedents can be established where it can be pointed out that in one case although the disclaimer had been used, the accountant still had made certain representations regarding valuation because of other information he obtained. How will the accountant who had made no such investigation, because he felt his disclaimer sufficient in his circumstance, answer this precedent? What standard will the laymen expect the accountant to follow if even a disclaimer is not sufficient to disaffirm responsibility? Where will the accountant's responsibility begin and end in an examination?

Of course if the accountant, through a very thorough examination, has discovered a serious violation of accounting principles then his disclaimer must include this, as well as the basic auditing procedures he did not follow, in citing the reasons for his disclaimer. However, if his engagement was limited in scope and the differences he has come across are arrived at by inference or conjecture without a thorough audit, then they have no basis in his report especially where he has already used a disclaimer regarding the asset.

Therefore, my opinion is that the accountant should not assume responsibility beyond the limits of his engagement. Third parties would do well to consider that the disclaimer indicates the limit of the accountant's engagement and his responsibility. Any further explanation beyond the disclaimer should be left to the discretion of the accountant.

David Shechet, CPA
New York, N. Y.

An Adirondack View

Initials are used too much instead of the full names of things, according to visiting students from other countries—per the radio. In our records the wife is F.G.H. and our assistant is J.M. We prepare a P&L and a BS for an accounting client.

For a corporation client we do a FTR and a 3CT—or perhaps a 42CT. Then for an individual we also do a NYTR and a DE—and he may have a S/E tax.

And we belong to the AIA which will soon be the AICPA. Once upon a time we got elected president of a chapter of the NACA.

And the class in Taxation comes to payroll taxes and gets tangled-up with the FICA and the D/B and the U/I.

What a mess. But the AMA is good news for us in this local branch of our illegitimate chapter. It—the AMA—has both the buildings and grounds of world-known Trudeau Sanatorium. Since the cure of TB (there we go again) changed to drugs and surgery, the need for Trudeau grew less and less. It closed, for lack of patients, a year or two ago.

The AMA — the American Management Association—is starting already in its plans for management conferences, classes, panels, workshops, et al, to be held here.

And so doth the city come to the mountains. And we will be seeing you at our conference in June at Saranac Inn. Yes?

Leonard Houghton, CPA
Saranac Lake Branch of
the "Adirondack Chapter"

Book Reviews

Office Work and Automation

By Howard S. Levin. John Wiley & Sons, Inc., New York, N. Y., 1956. Pages: xvi + 203; $4.50.

This book could very well be entitled "Automation as it may in the future apply to Office Work." The book is divided into five entirely separate and distinct chapters. The first one of only fifteen pages discusses in a general way the basic nature of office work, or "information handling" as the author prefers to call it, and the necessity for introducing more labor-saving methods. The second chapter is definitely a primer of the tools of integrated data processing. For the businessman or anyone not thoroughly conversant with the various integrating methods now being introduced into office work, this should provide a basic understanding of the general scope and uses of punched cards, five-channel paper tape and magnetic tape. For these devices the author prefers the term "common language machines" to the usual term "integrated data processing."

The third chapter, comprising one-third of the book, is devoted to electronic computers. This starts out with a description of electronic computers used in handling complex scientific and engineering calculations. Then we go to special purpose computers and, after the description and discussion of these, to the subject of computers used for assembling business information. This is practically synonymous with the use of computers in office work and this subject leads the author to a consideration of the many practical obstacles to be overcome in initiating an electronics program in the office. These difficulties include the selection of the proper machine, the high prices of these machines, the scarcity of people trained to analyze the information requirements and to program the work, and the strictly limited area of computer application.

With chapter four the author drops the discussion of integrated data processing and electronic computers and launches into a description and discussion of operations research. This discussion points out the advantages of applying scientific methods to business and enumerates some of the tools used for this purpose, including the various methods of sampling, the uses of statistical inference, scientific programming for finding the best way, the use of mathematical models and even such aids as the game theory and symbolic logic. This chapter is devoted to the application of operations research to business in general and is only slanted partially to its application to office work. This does not detract from the value of the material as the principles are the same and the most important practical uses of operations research have not yet been fully developed and may or may not be related to office work. Up to the present time they definitely have not been.

The last pages of the book are devoted to the chapter on "a changing office" which reviews the necessity for more automation in the office and more complete information for the business administrators of the future. In this chapter the author states that electronic computers are a tool that will reach maturity tomorrow and operations research the day after tomorrow. At the present time he, like the rest of us, is aware of the possibilities but also realizes that when we attempt to make practical application of them we run into many difficulties.

The book is written for businessmen and others engaged in management work for the purpose of providing them with basic information on these subjects and also pointing out some of the difficulties involved. The author is well equipped to provide this information. He has been a mathematician in the U. S. Air Force and a methods research officer for the Chesapeake & Ohio Railroad Company. At present he is a consultant with Ebasco Services, Inc.

Marshall Granger

New York, N. Y.

Federal Estate and Gift Taxes

By Charles L. B. Lowndes and Robert Kramer. PRENTICE-HALL, INC., Englewood Cliffs, N. J., 1956. Pages: xxii + 1028; $25.00.

A basic work on the substantive aspects of federal estate and gift taxes has been sorely needed by accountants and general tax practitioners not thoroughly versed in the complexities of these tax laws. Messrs. Lowndes and Kramer, professors of law at Duke University, have attempted to accomplish the admirable objective of providing such a text. Their work, though lengthy, is readable and ably written, having been designed and organized with a three-fold purpose in mind: to refresh the recollection of the experienced practitioner; to familiarize general tax practitioners with tax considerations involved in effective estate and gift tax planning; and to supply the student in textual form with the basic and fundamental principles of federal estate and gift taxes.

The federal estate tax, originally adopted in 1916 as an emergency measure, is now regarded as a permanent part of our federal tax system. Its primary purpose is to tax the transfer of property at death. Mechanically the tax is levied not only on testamentary and intestate transfers, but also on transfers which Congress has deemed to be their substantial equivalents. It is the sum total of all this property, called the gross estate, which provides the logical starting point for the study.

In addition to property owned by the decedent at death, the gross estate embraces transfers taking effect at death, such as transfers dependent upon survivorship, transfers with a reservation of a life interest, and revocable transfers. The authors, in a penetrating critique, review all the significant Supreme Court cases which have precipitated the complex statutory amendments aimed at developing a workable definition of "a transfer taking effect at death."

The areas of tax liability resulting from joint tenancies and tenancies by the entirety are explored quite comprehensively. Of unusual interest to the accountant, because of the frequency with which he runs into the problem, is the statutory scheme for taxing joint estates, particularly the taxation of joint bank accounts and the income tax basis of jointly-held property. Accountants will also appreciate the authors' mastery of their material on the subject of valuation for the estate tax since the determination of value at death or at the alternate valuation date can have a significant and far reaching effect on the

income tax liability of the beneficiaries upon a later sale of the property.

The task of explaining the allowable deductions from the gross estate—the $60,000 exemption, expenses and debts, losses, charitable and public gifts, and the marital deduction—has been expertly done in a relatively brief space with no sacrifice of technical accuracy. In particular, the six statutory requisites for the marital deduction are set forth with unusual clarity. As a concluding chapter to the section on estate taxes, the authors have provided a practical summary of estate tax procedures.

To supplement the estate tax and income tax, Congress, in 1924, enacted a gift tax which, because of an annual $50,000 exemption proved quite ineffective and was repealed two years later. The present gift tax was, as the authors point out, enacted in 1942 principally because of the decision in *Heiner* v. *Donnan* in which the Supreme Court held unconstitutional a conclusive presumption to the estate tax that gifts made within two years of death of the donor were in contemplation of death. To make sure that such gifts were subject to some tax, Congress adopted a tax on all inter vivos transfers. The history, purpose, and constitutionality of the gift tax, together with a full study of the nature of the tax, is presented in Part II of the work.

The authors have devoted a good portion of their study to tax planning for estates, bringing into play the principles enunciated in the earlier part of the text. It would have been helpful if the authors had included sample filled in schedules of the official estate tax form together with a reproduction of the official instructions accompanying the form.

Aside from a general criticism that any tax study in a bound volume may be rendered obsolete in time, the material presented should be of extreme value as a reference work to everyone concerned with estate and gift tax problems, particularly those practitioners who come in contact with these problems infrequently.

SAMUEL A. DYCKMAN

New York, N. Y.

Classified Section

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The President's Page

The Old Order Changes

It is interesting and stimulating at times to step outside of our own bailiwick and look at the profession of accountancy abroad. It gives us a new view of ourselves. For at least two years the most important Societies of Accountants in Great Britain have been discussing integration and have been keeping it a close secret. Late in December a memorandum was sent to all members of the Institute of Chartered Accountants of England and Wales, the Society of Incorporated Accountants, the Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in Ireland, proposing the union of these organizations. The result, if accepted, (as it probably will be) will be one organization of Chartered Accountants with 38,000 members. Two thousand of the present 11,000 members of the Society of Incorporated Accountants will not become Chartered Accountants but will remain Incorporated Accountants in the larger body with the right to become C.A.s on satisfying certain conditions. The Incorporated Accountants will become a dying class.

Inasmuch as it is not the State but the Institute that grants the Chartered Accountant designation and the Society the designation of Incorporated Accountant, the merger brings to our minds the CPA-PA discussions in this country.

To those who have visited England in the past twenty years (and have known the intense feeling of independence of the Institutes and the Society) this amalgamation comes as a surprise.

Undoubtedly one of the strongest elements in the success will be the long and mature consideration given to the proposal. Not only was the integration of the organizations long planned, but the recruitment of members, the merging of chapters (called

Districts), the finances, the publications and many other details were carefully spelled out.

Our own current experience with regulatory legislation is proving to be a similarly lengthy but equally orderly process. Our members were polled on two-class legislation last fall, the final result becoming known on November 26, 1956. The Council on Accountancy, which had held hearings on the subject, rendered a report to the State Department of Education about the same time. The next step was the preparation by Council of a draft of a bill embodying two-class legislation. This preparation, together with revisions and conferences, took much time and was not substantially in final draft form until February 11, 1957.

The legislative session which started January 7, 1957 is proving to be shorter than usual, and a deadline of February 19th was placed on the submission of bills by members. This time schedule seemed too short to permit of mature consideration of the bill by all interested parties in and out of the Society and too short for adequate review in Albany. It was, therefore, decided that an orderly process of consideration, of education and of consultation would be sounder than an attempt to rush a bill through in this short session of the Legislature.

The bill is in reasonably final shape and we expect to submit it to the authorities in Albany immediately following this session of the Legislature. Our members, and we hope all members of the Legislature, will be well informed on it before the next session of the Legislature begins so that the bill may have early introduction and consideration.

It is interesting that the procedure and timing are much the same in Great Britain and the United States. Let us hope that we can both follow out successfully the closer integration of the profession. As one looks over the ever broadening horizons of our profession, both at home and abroad, it is with a sense of quiet satisfaction that we are reminded of Tennyson's timeless words—*"The Old Order Changeth Yielding Place to New."*

ARTHUR B. FOYE,
President

Financial Management in the Federal Government

By Percy Rappaport, C.P.A.

The U. S. Bureau of the Budget is organizing to exert stronger leadership for bringing about improvements in budgeting, accounting and financial reporting throughout the Government, as recommended by the Hoover Commission and approved by the President.

Present-day management of financial operations in the Federal Government is the result of an evolutionary process that began with the establishment of simple cash controls to protect against the over expenditure of public funds. This evolution started with the recognition of commitments or obligations in the accounts—which were later budgeted and controlled in terms of a uniform classification of the kinds of purchases. Eventually, this uniform classification by "objects of expenditure" was supplemented by a schedule of financial information showing the kinds of programs and activities being carried on. This "activity schedule" then became the primary classification for management of financial operations.

The use of an activity schedule for each appropriation reflected a conceptual change in Federal budgeting that began many years ago, but was not completed until the Budget Document for fiscal year 1951. Its completion was brought about by adoption of a recommendation of the first (Hoover) Commission on Organization of the Executive Branch of the Government. In the subsequent development and refinement of this program and activity concept of budgeting and accounting, a gradual conversion to the cost basis of presentation and control was initiated, but the system in most agencies today still concentrates on the traditional obligation and cash disbursement basis.

Against this background, the second Hoover Commission submitted a Budget and Accounting Report to the Congress in June 1955, in which it stressed the need for more comprehensive use of the cost basis in financial management. Improvements toward the development and use of such data, which

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are now underway, recognize the need for accrual and cost information as well as obligation and disbursement data, in order to adequately manage and control program operations.

The expansion and growth of Federal activities in the last half century has been a primary factor in this evolutionary process. The increasing complexity of agency operations constantly posed problems of fund control and program management. These problems required answers for effective operation, leading to the current improvement of budget and accounting practices along lines not unlike those employed for financial management purposes in private industry.

There have been several developments of recent origin in this field that are most important. The Bureau of the Budget, among the central financial agencies in the Federal Government, is most directly involved. This article gives some background on this subject and provides a resumé of the Bureau of the Budget's action to foster and promote the widespread improvement of financial management in Government.

Background

Today, the Federal Budget for each fiscal year is the public expression of the President's financial plan of operation, and is used as the vehicle for promotion of improved management, planning, and control. In view of its relative importance to our national economy, it is hard to realize that until about 35 years ago, a unified budget presentation for the Federal Government did not exist. Instead, the Congress acted upon an unrelated series of requests for funds that were prepared by each department and simply printed and transmitted to the Congress by the Secretary of the Treasury. Little attention was given to the relationship of these requests, the total amount involved, or the effect of the proposed financial activities on the general economy of the country.

Origin of the Federal Budget

The expansion of Federal operations in the first World War and the resulting sharp increase in the public debt gave renewed emphasis to the attempts toward budgetary reform that had been made in the immediately preceding decade. The resulting action produced the Budget and Accounting Act of 1921 (42 Stat. 20). Under this Act the President, as head of the executive branch, assumed responsibility for the budget and brought to an end the concept of departmental self-determination. The Act established the Bureau of the Budget to provide the President with the staff assistance needed to carry out this responsibility. It also established the General Accounting Office as an independent agency in the legislative branch, with specified responsibilities for accounting and auditing. Both of the latter actions were accomplished by revision of the existing responsibilities of the Treasury Department.

Principal amendments to this 1921 legislation were effected by Reorganization Plan No. 1 (53 Stat. 1423) which transferred the Bureau of the Budget from the Treasury Department to the Executive Office of the President in July 1939; and by the Budget and Accounting Procedures Act of 1950 (64 Stat. 832). The Act of 1950 more clearly set forth the respective financial management responsibilities of the Bureau of the Budget, the Treasury Department, and the General Ac-

counting Office and, in recognition of their related functions, provided that these three agencies should conduct a continuous program for improvement of accounting and financial reporting.

Role of the Bureau of the Budget

In the Executive Office of the President, the Bureau of the Budget serves as the staff arm of the President in bringing about more efficient and economical conduct of operations in the executive branch of the Government. It works toward this goal by development and preparation of the annual budget, and by the improvement of management in execution of the financial programs approved by the Congress.

Development of the annual budget for the Government is a major job. Guidelines are established for presentation to the President, followed by a detailed and searching review of agency fund requests as a basis for assembling a sound financial program. As finally issued, the budget contains not only the financial plan for the coming fiscal year as approved by the President, but also presents background financial data for the current and preceding fiscal years. In addition, it contains a statement of policies in the President's Budget Message, and presents details on the nature of the programs planned for the budget year and the related authorizing legislation.

The managerial function of the Bureau is of commensurate importance. While the agencies are responsible for carrying out the programs approved by the Congress, the Bureau follows through for the President by reviewing agency execution of the budget to insure appropriate coordination. This is accomplished through analysis of financial and other reports of agency activities, and on-the-site review of agency operations. In this process, the Bureau gives attention to the relative efficiency and effectiveness of agency operations against the background of accepted management principles. Besides the operating divisions, which deal with the budget and operations of individual agencies, the Bureau has five staff offices which provide Government-wide coordination and assistance in several management areas. These include legislation, Executive orders, and other formal documents; the budget process; organization and general management practices; financial management activities; and the Government's statistical programs.

Improvement of Financial Management

Leadership for the improvement of financial management in the executive branch is vested in the Bureau's staff Office of Accounting. This Office conducts programs directed toward integration and modernization of the budget and accounting functions in the agencies. These activities are performed in cooperation with the General Accounting Office, the Treasury Department, and the executive agencies under the Joint Program for Improvement of Accounting. The latter is a coordinating mechanism that brings together the agencies assigned specific financial management responsibilities in basic legislation, so that effective progress may be made toward the mutual objective of improved financial management for the Government as a whole.

Role of the Joint Accounting Program

While the Budget and Accounting Procedures Act of 1950 provides legal

authority for the Joint Program for Improvement of Accounting, this cooperative effort actually began on an organized basis back in 1948. At that time, the activities of the Government had expanded and grown increasingly complex as a result of the second World War, and the management structure was gradually changing over to a decentralized basis of operation. The accounting processes were not keeping pace with these changes, and action was needed to make agency accounting systems more responsive to the needs of management. Since the program was initiated, great strides have been made in improving accounting and financial reporting operations in the Government.

Under the legislation now existing, the Bureau is responsible for budgeting and management generally; the Treasury Department is the central fiscal agency with responsibility for central accounting and reporting; the General Accounting Office is responsible for accounting principles, systems evaluation and approval, and audit of executive branch operations; and the operating agency is responsible for establishing and maintaining an accounting system designed to serve its own management needs and to meet established requirements. These responsibilities are coordinated in the Joint Accounting Program arrangements.

The work under this Program is organized and conducted on a joint project basis. Projects are established to resolve identified problem areas, and are carried out by staff of the several agencies involved. Operating in this fashion, the Joint Accounting Program has met with considerable success, as evidenced by the annual reports of progress published each year.

Bureau Participation in Joint Program

Since the inception of this joint effort in 1948, the Bureau's part in the program has been carried out by a small Accounting Group in the Bureau's Office of Management and Organization. The efforts of this Group were directed primarily toward coordination of the Bureau's budget and management activities with the development of accounting under the joint program. This has now been changed. The Accounting Group has become an Office of Accounting, which has been placed under the immediate direction and supervision of an Assistant Director of the Bureau.

This action was taken to give increased stature to the accounting improvement responsibilities of the executive branch. As a further step toward this goal, the Bureau of the Budget is now strengthening its staff facilities, and a good part of the additional staff has been assigned to the newly designated Office of Accounting. This Office will continue to work within the framework of the Joint Accounting Program, but with the additional staff available, will be able to participate in more joint projects and work more directly with the operating agencies. This will enable the Bureau to provide more effective leadership for the executive branch in the further development of financial management practices in the Government.

Hoover Commission Recommendations

The Budget and Accounting Report of the second Hoover Commission included 25 recommendations that made an important contribution to the further development of financial management throughout the Government. The establishment of the Office of Accounting is an outgrowth of these recommendations. The Commission also

recommended the Government-wide use of accrual accounting, including appropriate monetary property accounting records; the use of cost budgets internally in the agencies and—at the discretion of the President—for presentation of the executive budget; the use of data on cost of performance and accomplishments in support of the budget; the development of consistent budget and accounting classifications synchronized with agency organization structure; the simplification of allotment structure; the use of comptrollers in executive agencies; the improvement of central reporting for the Government as a whole; and simplification of certain fiscal procedures and practices.

Generally, the operating agencies expressed agreement with the Commission's recommendations or their objectives, and the Director of the Bureau of the Budget accordingly made plans for taking action on these proposals. These plans were approved by the President in a public statement issued on April 29, 1956, which reflected the position of the executive branch on this Hoover Commission Report. This was followed by a request by the President for a supplemental appropriation for fiscal year 1957 to enable the Bureau of the Budget to provide leadership for the executive branch in putting these recommendations into effect. This request included funds for more accountants so that the financial management activities could be expanded, and for additional organization and management specialists—to enable increased activity in the field of management review.

Related Legislative Action

The Congress approved supplemental funds for these purposes and gave further evidence of its interest in the Hoover Commission proposals by the introduction and consideration of numerous bills on the subject. After considerable study and testimony, two new laws were enacted in the second session of the 84th Congress—Public Law 798 (70 Stat. 647), and Public Law 863 (70 Stat. 782).

Public Law 798 permits agencies to pay their own claims, unless the transaction involves a question of law or fact requiring interpretation by the General Accounting Office. These "claims" represent bills that are chargeable to appropriated funds no longer available to the agency. Under previous practice, such bills could only be paid on certification by the General Accounting Office out of a central account in the Treasury Department that accumulated all lapsed agency funds. The main improvement in this change is the elimination of the duplicate review of such claims in the General Accounting Office.

The other new law, Public Law 863, represents a more important milestone in the development of financial management in Government. Among its most significant provisions are those for introduction of the use of cost data in governmental budgeting and accounting. These provisions will have an important bearing on improving the control and effective use of Government funds. In addition, Public Law 863 provides for showing the cost of performance and accomplishments in the executive budget; for the development of consistent budget and accounting classifications that reflect the agency's organization; and for simplification of the financing structure the agency uses to control the commitment of appropriated funds.

Accrual Accounting

Under Public Law 863, agencies are responsible for developing financial in-

formation on the accrual basis. This requires the use of an accounting system that records the receipt of goods and services and the use of resources, and reflects the assets and liabilities. To accomplish this effectively, the system must incorporate appropriate monetary property accounting to provide for recognition in the accounts of the agency's property, equipment, and inventories of materials and supplies.

While progress has been made by a number of agencies in installing such a system, many agencies still use the traditional accounting system in Government—which concentrates on fund control and fails to give adequate attention to liabilities and the dollar value of physical assets and operating inventories. This traditional system usually provides data only on obligations, which reflect the commitment of funds, and disbursements, which represent the payment of funds.

In accordance with the new law, accrual accounting systems will be developed in the agencies on the basis of the principles and standards issued by the Comptroller General. Using these criteria, an accrual accounting system in a Government agency develops information as needed on the costs of goods and services used, on accrued expenditures which show goods and services received, on disbursements that represent payments made, and on obligations that reflect orders placed. It incorporates financial controls that are consistent with management responsibilities—generally providing for broad fund controls in terms of limitations on obligations at a fairly high level of agency operations, and more detailed controls in terms of specific costs attributable to the agency programs. In contrast to the traditional system in Government, an accrual accounting system thus reflects not only the availability of funds, but also shows the resources on hand, and the actual use of such available resources.

It is neither feasible nor desirable, however, to apply a uniform system Government-wide. The degree to which the accrual basis will be applied in individual agencies varies with the kind of operations conducted by the agency, and the needs of management for accrual or cost information. Basically, under Public Law 863, all agency systems should produce at appropriate time intervals information on accrued expenditures. Depending on the type of program conducted by the agency, there may be a need for information on the cost of goods and services used, the cost of items procured or produced, or the cost of work in place. Accordingly, the accrual basis will be applied in each case to the extent that the additional information obtained will be more useful to agency management, and provide for better disclosure of financial status and operational results to the various levels of management in Government.

Cost Budgeting

Public Law 863 provides that cost budgets are to be used internally, and in support of appropriation requests at the direction of the President. While cost budgeting practices are currently in use in some agencies, the budget request in most instances is based on obligations. In such cases, funds are requested in terms of the authority required to place orders for goods and services. Such a presentation reflects primarily the procurement plans of the agency; it fails to provide data on the costs of operations, or on the use of the goods and services already procured and available to the agency.

In contrast, the cost-based budget relates accomplishments and future work plans to costs in terms of resources consumed, work in place, or items procured or produced. Such a budget also identifies the inventories and other resources on hand which are available for application to the program financed by the appropriation, the value of goods and services that have been ordered but have not been received, and the total obligations required to finance the program. Briefly stated, it presents the total financial plan of operation as opposed to a mere presentation of the financing needed for the budget year, and is of major benefit for review and analysis of a budget request.

The significance of a cost-based budget varies with the type of program conducted by the agency. Where large inventories and long lead-time programs are involved, the cost-based budget provides its greatest benefit because of the identification of carry-overs of available resources. In addition, the evaluation of long-range programs is improved because of the identification of use of resources in relation to the time period involved. The Bureau of the Budget plans to use cost-based budgets in the future to the fullest extent practicable, and will place immediate emphasis on those appropriations in which the conversion will produce major benefits for management and provide for more complete disclosure.

Related Objectives

Accounting and budgeting on a cost basis are but two of the major objectives of Public Law 863. Others of similar significance, as mentioned above, are concerned with the agencies' allotment structures, and the classifications used by the agencies for budgeting, accounting, and control.

The law requires simplification of the allotment structure the agency employs to control the use of available funds. The past concentration on obligation accounting has in many cases led to the establishment of a multiplicity of obligation allotment accounts. The current effort will emphasize the use of allotment accounts at the highest practical level, to serve only the primary purpose of fund control. These control accounts will be supplemented by appropriate detailed cost classifications developed to provide the necessary management information.

Public Law 863 requires that budget and accounting classifications be consistent and synchronized with the agency organization structure to the extent possible. This reflects the desirable objective of using common classifications for programming, budgeting, accounting, and reporting. The evolution of financial management in the Federal Government produced a complex of budget and accounting classifications that were not always consistent with each other nor with the manner in which the agency conducted its operations. While corrective action has been taken from time to time, this requirement in the new law places emphasis on a re-evaluation of present practices as part of the development of the agency budget and accounting system—to insure the establishment of these classifications in appropriate relationship.

Bureau Program for Improvement

The enactment of Public Law 863 provides the broad outline of immediate objectives in implementation of the Hoover Commission proposals. The

Bureau of the Budget makes use of this framework in its *Bulletin No. 57-5*, which was released on October 10, 1956, to initiate an organized Government-wide improvement program. A pamphlet, entitled "Improvement of Financial Management in the Federal Government," was attached and distributed as part of the Bulletin. This pamphlet identifies all factors having a bearing on this program and was developed to insure complete understanding of executive branch policies and the basis for this improvement effort. It should be helpful in bringing about the mutual understanding needed to produce the desired results.

Bulletin No. 57-5 requires each executive agency to develop a planned program for improvement of its financial management practices for submission to the Bureau of the Budget. This program is required to follow the policies set forth in the attached pamphlet, and is to include any action necessary to conform to the Budget and Accounting Procedures Act of 1950, other similar legislation applicable to the particular agency, Public Law 863, and, within the provisions of existing law, the objectives of the Hoover Commission budget and accounting recommendations that are not covered by Public Law 863.

The agency programs will be the medium for merging the related interests of the three central agencies involved in the Joint Accounting Program. After review of the agency programs, the Bureau of the Budget will arrange with each operating agency for a joint discussion of its plans, together with representatives of the other central agencies. The purpose of these discussions will be to insure mutual agreement and coordination of efforts toward the identified objectives, to provide needed guidance and assistance under the joint program arrangements, and to establish suitable methods for following up on the agency's progress in carrying out the program.

In the final analysis, the degree of success that is attained in this program is admittedly dependent upon the efforts of the individual operating agencies. While staff of the three central agencies will provide such assistance as they can under the Joint Accounting Program, the job ahead basically is a responsibility of the operating agency. Each one is expected to develop an improvement program which reflects an application of the established policies that is appropriate to its needs; to provide for assignment of the staff necessary to do the job; and to carry out the program as rapidly as possible.

Conclusion

Financial management staff in the operating agencies have an important role to play in this effort. Theirs is the job of obtaining a clear understanding of the objectives sought and applying that understanding in the resolution of problems that arise in the conversion of agency budget and accounting systems. Similarly, the Bureau of the Budget and the other central agencies also have an important role—one of clearly setting forth the policies and instructions to be followed, assisting and coordinating agency efforts to produce consistent results on a Government-wide basis, and stimulating rapid progress toward the established objectives. In total, the job ahead is for everyone concerned to apply initiative and understanding to this undertaking, so that the Federal Government can soon enjoy the benefits that can be derived from modern and effective financial administration.

How to Audit a Small Bank

By F. Clyde Lambert, C.P.A.

This article is based on experiences gained by the author in serving small and medium size banks. It deals with the responsibilities of bank directors for examination of their banking institutions and the way the independent certified public accountant can assist the directors in carrying out their examination responsibilities.

Responsibilities of Directors

The directors of banks, both federal and state-chartered, are required to keep themselves informed of the bank's financial condition and other affairs of the bank which might affect the institution's solvency, stability, or prosperity. This obligation is assumed by them when they accept a directorship in the banking institution, and the inherent responsibilities of the directorship can be ignored only at the peril of the director. One of the duties imposed upon directors as a means of keeping themselves informed about the bank's affairs is the requirement that the directors make an examination of the bank's financial and other affairs periodically. The number of these examinations varies among the various regulatory authorities, but, generally, a complete examination is required at least annually.

Directors' Examinations

The principal points that should be covered by the directors in the course of their examinations of national banking institutions are contained in a booklet on directors' examinations which can be obtained from the Comptroller of the Currency. The requirements inherent in the responsibilities for directors' examinations of state banking institutions are similar to those of the national banks. All states and the Comptroller of the Currency permit, and a few states require, the examination of the banking institution by independent certified public accountants as a substitute for the directors' examinations.

Examination of banking institutions by federal or state regulatory authorities is primarily for determining the solvency of the institution. The findings of the regulatory authorities can assist the director in keeping himself informed about the bank's affairs, particularly as to credit-risk evaluations, but the governmental examinations do

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not satisfy the directors' responsibility for examining the bank's affairs.

The directors of many banks, particularly those of small banking institutions, make the examinations themselves of the banks' affairs to meet the statutory examination requirements. These examinations are usually extremely limited and, actually, probably are not sufficient. Of course, the director exposes himself to considerable hazard if some catastrophe occurs about which he should and could have known from a proper directors' examination.

CPA Assistance

Many small banks or the directors of the banks engage firms of independent certified public accountants to assist them in their examining responsibilities. In these engagements, the independent certified public accountant must act as the eyes and ears of the directors in obtaining information about the bank's affairs, and should keep in mind the objective of obtaining and transmitting to the directors all of the information falling within the province of the accountant that the directors should know concerning the solvency, stability, and prosperity of the institution.

Two Examination Phases

An examination of a small bank is best conducted in two separate, but integrated, phases:

1. A far-reaching search and investigation of the system of internal check and control, and extensive tests and reviews of recorded transactions and operations of the bank.
2. Examination of the bank's financial condition at a selected date.

Principal Elements of the Audit

In the audit of any bank, there are three principal elements which must be recognized and provided for in the planning and operational stages:

1. The element of surprise. The examination must be undertaken without notice to anyone in the bank. The fluidity and mass of detail inherent in the flow of cash and other banking transactions require that the examiners look at the financial affairs of the bank and the conditions existing before any artificial or false adjustments may be made to conceal irregularities.
2. The element of control. In order to continue the surprise effect discussed above, control must be immediately established over cash and cash items, clearings, investment securities, loans and discounts, mortgages, and other liquid assets and the related records. The control may be released piecemeal as examination of each category is completed.
3. The element of adequate scope and extent of audit procedures. The scope and nature of audit procedures in the audit of a bank have been well defined in many excellent publications and will not be repeated here. An excellent program of bank audit procedures is contained in "Suggested Scope of Bank Audits by Independent Public Accountants", prepared under the joint sponsorship of the New Jersey Bankers Association and the New Jersey Society of Certified Public Accountants published September 1956. The extent of the tests and verification is, as always, within the judgment of the independent cer-

tified public accountant, who must extend his audit procedures as far as necessary to satisfy himself as to the reliability and validity of his findings and conclusions.

These elements apply in both phases of the audit of a small bank. The independent certified public accountant must develop and carry out whatever measures are necessary to effect a proper audit according to the conditions and circumstances found at the particular banking institution being audited.

Internal Control

An essential procedure in the investigation of the system of internal check and control is the completion of a questionnaire on the system of internal check and control to insure that all of the facts of the particular function being audited are given consideration in the audit procedures. A satisfactory form of questionnaire is included in an "Audit Program for the Smaller Bank" prepared as a project of the Research Committee of the National Association of Bank Auditors and Comptrollers and published in August 1946.

Time of Examination

The audit of the system of internal check and control, testing of recorded transactions, and review of operations of the bank are best carried out by two or three surprise visits over a year's time (or perhaps a longer period). At each visit, a selected phase (or phases) of the institution's banking functions is examined, tested, searchingly investigated, and findings and conclusions reported to the auditing committee. By conducting this phase of the audit in this manner, several things are accomplished:

1. The benefits of the element of surprise are multiplied, since the bank employees are not informed as to either the date of the two or three visits each year or the functions which will be audited at each visit.
2. Internal auditing procedures, which could also form part of the annual examination, can be carried out with continuity and provide internal auditing facilities which would not be available otherwise to the small banking institution. This type of service would probably be additional to the minimum scope of an audit, and separate arrangements would have to be made, but it is well worth the additional cost that would be involved.
3. The work is spread during the year and, to a very great extent, has the same beneficial effect psychologically that a continuous audit performed by an internal audit staff would provide. The spreading of the work, of course, also, as a by-product, will usually be of benefit to the independent accountant.

Method of Participation by CPA

The independent certified public accountant may make, or participate in, the audit of the bank's financial condition at a given date on behalf of the directors by:

1. Conducting the audit entirely with personnel from the independent certified public accountant's staff.
2. Conducting the audit utilizing, to the extent possible, the bank's own personnel under proper controls and supervision of the independent certified public accountant.
3. Lending technical assistance and control during the course of an audit conducted by the directors

themselves with the assistance of the bank's personnel.

Which of the above arrangements are used will depend on the bank management's judgment as to the best balance between cost expended and results obtained. Obviously, the greater the utilization of the independent certified public accountant's services, the higher the cost to the bank but also the better the results.

Presented as an appendix to this article is a general outline of the procedures followed in a recent engagement in which the directors of a bank (having $15,000,000 in total resources) carried out their directors' examination with the assistance of bank personnel and under the technical supervision and control of an independent certified public accountant. In this engagement, the independent certified public accountant also visited the bank two other times during the year to carry out tests of operations and the review of the system of internal check and control, and to confirm selected depositors' and borrowers' accounts.

Outside Verification

Independent certified public accountants should urge, and practically insist upon, the verification of loans and discounts, by direct communication with the borrowers or depositors. There is no adequate audit procedure to substitute for the direct-verification procedure, and the system of internal check and control cannot be completely investigated without the direct-verification procedure.

The Audit Report

The report on the audit may be prepared by the independent certified public accountant as his own report or may be prepared by him, in draft, for issuance by the auditing committee itself, depending upon the nature of the engagement. Reports should contain a statement of the financial condition of the bank and any comments on the items and amounts shown. A detail statement of worthless loans, etc., should be included, along with lists or schedules of other significant items such as, perhaps, investment securities, substantial investment in banking property or fixtures, and like matters.

The reports should also contain a statement of any conclusions or exceptions the audit committee may develop with regard to the bank's solvency, stability, or operational policies. An excellent general outline of a report by the audit committee of a bank is contained in the "Audit Program for the Smaller Bank" referred to above.

The Value of CPA Service

The independent certified public accountant can render a very valuable and needed service to banking institutions and the directors of the banking institutions. Bankers and directors of banks are increasingly growing aware of the benefits, and their need for the benefits, to be derived from the services of independent certified public accountants. By studying the problems of each banker-client and providing services accordingly, the independent certified public accountant can render services that will contribute to the betterment of the profession of public accounting, the banking fraternity, and the community at large.

Appendix

General Outline of Directors' Examination and Personnel Requirements

Introductory Comments

This outline is applicable where the independent certified public accountant lends technical assistance and supervision of an examination conducted by the directors with the assistance of bank personnel.

The basic audit requirements are in accordance with the suggestions by the Comptroller of the Currency of points to be covered in the directors' examination. The following procedures provide organization of the details of performance of the basic audit procedures.

General

One officer, accompanied by a director, should seal all vaults, note cases, and other places where needed, including the trust department. These seals should not be broken until released by a director of the audit committee.

List of bills payable as of examination date will be prepared and furnished to representative of CPA & Co.

Personnel requirements:

Bank: One officer and one employee.

Directors: One.

Representative of CPA & Co. will examine the following:

Last call statement.

Statement of condition at date of examination.

Last report of federal bank examiners.

At the conclusion of the examination, the results will be discussed by CPA & Co. representative with the audit committee, and any exceptions or deficiencies will be considered for appropriate action and recommendations to be made to the board of directors.

Cash

Cash at all locations will be counted simultaneously with rotated bank personnel under the supervision of an officer of the bank.

Summaries of the cash count will be furnished to CPA & Co. representative for comparison with general ledger controls.

Cash items will be listed and their disposition and validity traced by the officer in charge of the count.

CPA & Co. representative will verbally report to the auditing committee the results of the cash count.

Personnel requirements:

Bank: One officer in charge; sufficient personnel to make count.

Directors: None.

Demand Deposit

Adding machine tapes will be run on all demand deposit ledgers by rotated bank personnel under the supervision of an officer.

Totals of the tapes will be compared with sub-ledger controls. Discrepancies will be reported to and resolved under the direction of the officer in charge.

Sub-ledger totals will be summarized and compared with general ledger controls by CPA & Co. representative.

CPA & Co. representative will verbally report results of examination to auditing committee.

Overdrafts will be listed by name and amount and the list furnished to the auditing committee.

Auditing committee will scrutinize list and inquire into any overdraft of a questionable nature or size.

Personnel requirements:

Bank: One officer in charge; sufficient personnel to run tapes on all ledgers.

Directors: One, part-time.

Savings Deposits

Adding machine tapes will be run on all savings accounts (including Christmas savings accounts) by rotated bank personnel.

Confirmation requests will be prepared for accounts selected by the officer in charge.

Tapes will be compared with general ledger balance by CPA & Co. representative.

CPA & Co. will control mailing of confirmation requests.

Personnel requirements:

Bank: One officer; sufficient personnel to run tapes and prepare confirmation requests.

Directors: None.

Securities—Owned by Bank

List securities owned by the bank on work paper provided.

Submit tape of cost column to CPA & Co. representative for comparison with general ledger.

Securities on hand will be inspected by an officer and a director or his appointee.

Confirmation requests should be prepared on securities out for safekeeping.

CPA & Co. will control preparation and mailing of confirmation requests.

Director or his appointee will ascertain market value.

Personnel requirements:

Bank: One officer; sufficient personnel to accomplish above procedures.

Directors: One.

Securities—In Safekeeping for Customers

Prepare list of all securities (except collateral) which are held by the bank for safekeeping, listing the owner's name and reason why security is held. Submit list to CPA & Co.

Personnel requirements:

Bank: Sufficient number of rotated employees to list securities; one officer; custodian of securities.

Loans

Adding machine tapes will be run on all loan accounts. Tapes will be compared with general ledger balances by CPA & Co. Lists will be prepared on the following types of loans:

1. Amounts due from directors, officers and employees.
2. Loans exceeding 10% of the capital and surplus.
3. Past-due loans (segregate loans in hands of attorney).
4. Indirect liabilities of officers and directors.

Directors will inspect authorizations, collateral and such other documentation as considered necessary to evaluate the loans.

Personnel requirements:

Bank: One officer; sufficient rotated personnel to run tapes of the loans.

Directors: Two.

Certificates of Deposit

List (or run a tape), under supervision of an officer, all outstanding items. CPA & Co. representative will compare total with balance shown in general ledger.

Personnel requirements:

Bank: One officer; one rotated employee.

Directors: None.

State, County and Municipal Deposits—Personal Loan Deposits—U. S. Post Office Department Postal Account—Federal Safe Deposit Tax

Run adding machine tapes of accounts where appropriate. CPA & Co. representative will compare tapes with general ledger balances.

Personnel requirements:

Bank: One officer; sufficient number of rotated personnel to perform the above.

Directors: None.

Reconciliation of Outstanding Items

Prepare reconciliations of outstanding certified checks, cashiers checks, etc. under supervision of an officer.

Officer to verify accuracy by reference to books of original entry, stubs, etc. and subsequent clearings.

Reconciliations will be compared with bank's records by CPA & Co. representative.

Personnel requirements:

Bank: One officer; sufficient number of rotated personnel to prepare reconciliations.

Directors: None.

Reconciliations of Correspondent Bank Accounts

Latest reconciliations of accounts with correspondent banks will be furnished CPA & Co. representative together with transcripts of accounts from date of reconciliations to examination date.

Confirmation requests will be sent to correspondent banks under control of CPA & Co.

Officer will supervise and verify accuracy of reconciliations and transcripts.

CPA & Co. will direct mailing of confirmations.

Personnel requirements:

Bank: One officer; sufficient number of rotated personnel to prepare transcripts of accounts and confirmation requests.

Directors: None.

Capital Stock and Minutes

List capital stock outstanding by name and number of shares.

Bank's attorney will examine capital stock stubs and review minutes of meetings since the last examination.

Personnel requirements:

Bank: One employee.

Directors: One.

Income

Tests of income from all sources will be made by the bank's chief accounting officer and a director and traced to books of original entry, and to general ledger.

Personnel requirements:

Bank: Chief accounting officer.

Directors: One.

Collection Account

List or run tapes of balances in this account.

Confirmation requests will be prepared (on a test basis) and mailed, especially on larger amounts, by CPA & Co. representative.

Personnel requirements:

Bank: One officer; one employee.

Federal Reserve Bank—Reserve and Capital Stock Accounts

Confirmation request will be pre-

pared and mailed by representative of CPA & Co.

Over and Short

Account will be reviewed by the officer in charge for a test period and report made on any major discrepancies.

Personnel requirements:
Bank: One officer.
Directors: None.

Expenses

One or more directors will scrutinize expenses for selected periods, and will request vouchers for comparison with disbursements at their discretion.

List of questionable expenditures will be prepared by the directors and submitted to the audit committee for appropriate action.

Personnel requirements:
Bank: None.
Directors: Two.

General Ledger

CPA & Co. representative will compare balances in general ledger with daily report of financial condition.

Personnel requirements:
Bank: None.
Directors: None.

Trust Department

Count cash, run tapes of uninvested cash, corpus accounts and income accounts, and perform such other auditing procedures as considered necessary.

Personnel requirements:
Bank: Sufficient number of personnel to accomplish this under supervision of an officer.

Credit Unions And Mandatory CPA Audits

During the past year, it has become increasingly evident that the work of the supervisory committee in many of our state-chartered credit unions has not been satisfactory. In some cases the reason apparently was a lack of technical knowledge on the part of the individual members; in others, lack of interest in the affairs of the credit union and insufficient time allocated to its affairs . . .

Based upon the Department's continuing review of this situation, it has been found necessary in a number of instances during the current year to insist upon the engagement of a qualified independent accountant to make a complete audit of the books and records of the credit union; the audit to include a mail verification of all assets, liabilities, members' share and loan accounts, and a test of income and expense. This policy will continue.

The Department also has under consideration a proposal that would require, either through an amendment to the Banking Law or by regulation, that each credit union be audited annually by qualified independent accountants in a satisfactory manner.

from the 1956 Annual Report, *Superintendent of Banks, State of New York, December 31, 1956.*

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Collapsible Corporations

By FRANK M. BUDIK, C.P.A.

A discussion on developments since the promulgation of regulations on reorganizations.

Since the enactment of the 1954 Code and the promulgation of regulations in December of 1955 on collapsible corporations, there have been a few rulings issued by the Commissioner of Internal Revenue which have elaborated on the subject but there have been no court decisions which are of any help.

Purpose of Code Sections Pertinent to Collapsibles

The purpose of the sections dealing with collapsible corporations is to tax as ordinary income, gain on disposition of stock which would otherwise be taxed as long-term capital gain. In order for such gain to be taxed as ordinary income, the corporation must have been formed or availed of for the purpose of converting ordinary income into capital gain for the benefit of the shareholders. The excess of the tax which results from treating gain on disposition of stock as ordinary income, instead of capital gain, may be called a penalty tax. This tax is imposed on somewhat the same ground as the tax on the improper accumulation of surplus; both penalty taxes go to the intent of the shareholders or the persons in a position to determine the policies of the corporations. It can be differentiated from the penalty tax levied against personal holding companies because neither the intent of shareholders, nor the purpose for which the corporation was organized or utilized, has any effect on the circumstances which cause a corporation to qualify as a personal holding company. Generally, it is relatively simple to determine the personal holding company status of a corporation. To determine the collapsible status of a corporation is not a simple matter, except in obvious situations.

It is rather doubtful that corporations have been formed with the intent of coming within the sections pertaining to collapsible corporations. Nevertheless, there are probably a good many cases where the disposition of stock of existing

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This article is an adaptation of a paper presented by the author at the October 18, 1956 and November 7, 1956 technical meetings held in New York City and Syracuse, respectively, under the auspices of the Committee on Federal Taxation.

corporations would be treated as ordinary income without the stockholders or its officers being fully aware of that fact.

Published and private rulings issued by the Commissioner and discussions with officials of the Internal Revenue Service seem to indicate that the administration of those sections will be on a realistic basis.

Parent-Subsidiary Affiliation

Thus, in one published ruling the Commissioner relies on the intent of the statute and not the result which is produced by a literal meaning of the section. The definition of a collapsible corporation includes a corporation which holds stock in such corporation. In other words, in a parent-subsidiary affiliation, if the subsidiary is collapsible, so is the parent. The Commissioner ruled that gain realized on disposition of the stock in the subsidiary by the parent is ordinary income but that gain realized by the shareholder of the holding company on subsequent disposition is capital gain. Technically, the parent company is still a collapsible corporation even though it has been taxed as the shareholder of a collapsible corporation, since the statute refers only to the realization of taxable income by the corporation producing the property, and not to any realization by the corporation holding its stock.

Foreign Corporations

Similarly, the Commissioner has ruled that a foreign corporation operating and deriving income in a foreign country will not be considered a collapsible corporation. It should be noted that no distinction is made in the Code sections under discussion between domestic and foreign corporations.

Shareholders' Intent

The matter of intent of the shareholders was taken into account in a ruling involving inventories. Inventories is one of the assets which may cause a corporation to be classified as collapsible. A corporate taxpayer, engaged in the business of selling ore drilling equipment in a particular area, suffered a reduction of sales due to competition. Furthermore, a survey indicated that the number of equipment supply houses in the area was out of proportion to the number of drilling rigs in operation. Accordingly, it reduced its sales staff and other expenses and curtailed its inventory purchases to the requirements of the business. The corporation was liquidated, the inventory was transferred to a partnership, composed of former stockholders, which continued the business. Based on the facts and since the inventory was normal for the purpose of an orderly liquidation of the business, the ruling held that gain on liquidation is not taxable as ordinary income.

Three-year Holding Period

One ruling pertains to the three-year holding period following the completion of manufacture, construction, production or purchase of property. The penalty tax does not apply where property has been held by the corporation for three or more years. It is of importance however to determine when the three-year period begins. In this ruling the taxpayer acquired property for the purpose of constructing a shopping center and then applied to the town authorities for rezoning. Final rezoning became effective some time after the purchase of the property. In this situation the Commissioner reasoned that the rezoning constitutes an integral step in the construction of the shopping center, and

since the corporation had no other construction activity subsequent to the date the rezoning became final, the three-year period began on the latter date.

Justifiable Disposal of Stock

If a corporation qualifies as a collapsible corporation but the sale, exchange or other disposition of the stock by the shareholders is attributable solely to circumstances which arose after the manufacture, construction, production or purchase of property, then the corporation shall be considered not to have been formed or availed of for the purpose of converting ordinary income into capital gain. This statement is contained in the regulations and has been borne out by special rulings to taxpayers. Thus, where sale of stock in a collapsible corporation is made because of serious illness of a shareholder, who required the proceeds to pay for medical expenses, capital gains tax would result. Another situation might be where a stockholder is required to dispose of stock prior to entering the government service.

It is to be expected that the Service will attempt to assess the penalty tax in those cases where the shareholders cannot demonstrate that their intent in forming or utilizing the corporation was not to convert ordinary income to capital gain for their benefit.

Conclusion

In the situation where a collapsible corporation exists, there are several methods of avoiding the penalty tax other than waiting for the three-year holding period to elapse. A tax-free exchange of stock for stock would not precipitate the tax. The Code provisions relating to collapsible corporations change long-term capital gain to ordinary income but do not change the nature of a short-term capital gain. Accordingly, if the stock of the collapsible corporation is held for less than six months it may be appropriate to dispose of the stock provided the tax payer has capital losses against which to offset the short-term capital gain.

In any case the penalty tax should be kept in mind whenever business men or investors dispose of stocks in corporations that might qualify as collapsibles and also when there is an acquisition of stock in a collapsible corporation, as it is not necessary for a person to be a shareholder at the time of manufacture, construction, production or purchase of the property, in order to be assessed the penalty tax on the gain on subsequent disposition.

Differences Between Taxable And Ordinary Income

If, because of differences between accounting for tax and accounting for financial purposes, no income tax has been paid or provided as to certain significant amounts credited to surplus or to income, disclosure should be made. However, if a tax is likely to be paid thereon, provision should be made on the basis of an estimate of the amount of such tax. This rule applies, for instance, to profits on instalment sales or long-term contracts which are deferred for tax purposes, and to cases where unrealized appreciation of securities is taken into the accounts by certain types of investment companies.

from Accounting Research Bulletin No. 43, *the American Institute of Accountants, 1953.*

Village Budget Preparation and Management

By JOSEPH M. CUNNINGHAM, C.P.A.

A discussion of the basic principles and procedures for village budget preparation and management. A sequel article by the author will be devoted to a presentation and analysis of the recently promulgated New York State Uniform System of Accounts for Villages.

Fortunately for the villages of New York State, the Village Law, as recently amended, and the Village Budget Manual of the State Comptroller establish procedures which are based on the most modern concepts of local government budgeting. The basic requirements which have been established cover a complete financial plan, but nevertheless leave considerable room for adaptation to local requirements.

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The author's varied experience includes service as First Deputy Comptroller of the City of New York. He is presently engaged in practice as a Certified Public Accountant in the City of New York.

A budget has many uses, but certainly one of the most important purposes is to give to the voters a full and complete disclosure of the financial plan of the elected officials for the ensuing year. The kind and quality of services performed by the village, will depend, in the final analysis, on the desires of the voters, and the budget document is certainly essential for a determination of this question. The application of this policy of complete disclosure has been a basic consideration in the establishment of the budget requirements by the State.

Basic Principles

Before discussing the procedures involved in the formulation of the budget, it would be well to consider certain general principles which underly these procedures.

1. There is the principle of the balanced budget. The law requires that revenues and appropriations must be balanced when the budget is adopted, and that this balance be maintained throughout the fiscal year.

2. The budget must be adopted prior to the beginning of the fiscal year, which represents a major change from present village practice. The dates for the preparation and adoption of the budget have been carefully arranged to coordinate with tax assessment and levy, so that tax collections may commence on the first day of the budget year.

3. The budget must include all revenues and expenses of all the funds of the village, with the exception of the electric, gas and steam funds. Thus the budget represents a complete statement of all elements of the village's finances, with the exception noted, and gives everyone concerned an overall view of the program for the ensuing year.

4. It is provided that there must be an appropriation for every expense of the village; and that these appropriations must be classified according to the Uniform System of Accounts established by the State Comptroller. As a result, the budget, accounts and reports of the village are unified and coordinated.

5. Appropriations must be made by administrative units, so that responsibility for their expenditure may be placed on the head of that unit.

Preparatory Decisions by Village Officials

Before inaugurating the new budget system, certain decisions must be made by the village officials.

1. The appointment of a Budget Officer should be made by the Mayor (or Village Manager) if he himself does not desire to act in that capacity. It is advisable to make such an appointment in all villages, since both the Mayor and Manager have many other duties. The chief fiscal officer should also be the budget officer, since the duties of budgeting, accounting and reporting can best be coordinated by one official. In case the Village Clerk is the only full-time official, it is my opinion that he should be made Clerk-Treasurer, and thus recognized as the chief fiscal officer. The unofficial assumption of financial duties by the Clerk should be avoided.

2. A Classification of Accounts for the Village should be adopted. This classification will list the fund, the revenue, and the appropriation (expense) accounts, and in the double entry villages, the balance sheet accounts. The accounts which will be used by the village will be selected from those listed in the Uniform System. Sufficient copies of the Classification of Accounts should be available to those concerned with the budget.

3. Forms should be designed and mimeographed for use during the budget process. Examples are given in the State Comptrollers Manual, which can be adapted to local usages.

Significant Dates

The preparation of the budget commences about February 1st, and becomes effective on June 1st in most villages. Certain exceptions are permitted which need not be discussed here. During this same period, the tax assessment procedures are completed and the levy of taxes is made by May 15th. The extension of the tax roll is completed by June 1st, and on that date the collection of taxes is commenced. Thus, current revenues begin to flow into the village the first day the budget is effective, so that there should be no necessity for

borrowing funds on a temporary basis to finance the new year, as was frequently necessary under the old budget system.

Steps in Budget Development

The development of the budget from the point of view of the Budget Officer, follows these basic steps:

1. Development of the Departmental Estimates.

2. Review of these estimates by the budget officer.

3. Preparation of the tentative budget.

Departmental Estimates

The Budget Officer is required to notify the Department Heads, in writing, by February 8th of the necessity of submitting departmental estimates of revenues and expenses. He must specify the form of those estimates, and state the information they should contain. The amount of detail requested should be at least equal to the detail which the Budget Officer is required to show in the tentative budget. In requesting departmental estimates, it is advisable for the budget officer to specify that each department head should explain the activities of the unit, give statistics regarding the volume of work to be performed as compared with prior years, and explain fully any new activities budgeted. In other words, each responsible executive should justify the expense of his unit. This applies particularly to street cleaning, highway repairs, street lighting, and other measurable activities.

The Budget Officer should provide forms on which the estimates will be submitted. Two forms will usually be sufficient, one for appropriations and one for salary detail, in addition to a covering memorandum from the unit or department head. The appropriation form might have the following columns:

1. Administrative unit and account.
2. Last completed year.
3. Current budget as modified to date.
4. Departmental request.
5. Budget Officer's recommendation.

The Budget Officer should fill in all necessary information and amounts on the form, except in the "Departmental Request" column, since data should be readily available from his records after the system has been in operation for a few years.

The form for salaries and wages should have columns for:

1. Job Classification.
2. Number of Employees.
3. Present Rate of Pay.
4. Present Salary or Wage Annual Basis.
5. Departmental Recommendation.
6. Budget Officer's Recommendation.

This form should be filled out in detail by the Budget Officer from the payroll records for the individuals or groups of personnel on the last payroll. Vacant positions should be listed separately and marked "Vacancy". The department should be instructed that if additional positions are desired they should be entered at the bottom of the list, with an explanation of the necessity for the addition.

Review of the Departmental Estimates

The Budget Officer should make a detailed review of the departmental estimates, and form his own opinion as to the requests submitted. In making this review, the activities, volume of work, methods of operation, and organization should be considered, and budgeted

costs discussed with the department head and, if necessary, the mayor or manager. This review of departmental activities and expense can be a very valuable aid in the efficient management of the village. While it is made at budget time, it should be continued all during the year, so that there will be a constant scrutiny of the activities and expense of the village.

The departmental estimates of revenues should also be carefully checked, and revised if considered advisable by the Budget Officer.

Preparation of the Tentative Budget

By March 20th, the Budget Officer must file with the Village Clerk a tentative budget showing:

1. Last completed fiscal year.
2. Present budget, as modified to February 8th.
3. Budget Officer's recommendation.
4. Adopted (Blank Column).

Form of Budget

The form of the Budget is governed by the State Comptrollers Manual and consists of the following sections:

1. Statements Summarizing the Budget:
   Exhibit A—Summary of Budget, By Funds.
2. Statement Showing Budget Details:
   Schedule 1—Appropriations, by Funds.

   Schedule 2—Estimated Revenues Other Than Real Estate Taxes to be Levied, by Funds.

   Schedule 3—Estimated Cash Surplus at End of Present Fiscal Year, All Funds.

   Schedule 4—Statement of Reserve Funds.

   Schedule 5—Salaries and Wages, All Funds.
3. Utility Operations:
   Statement 1—Estimated Electric Utility Operations.

In preparing the tentative budget, the Budget Officer may make such changes as he believes advisable in the Departmental Estimates, but must balance the budget, according to the following formula, for each fund:

Total Appropriations	$——
Less Estimated Revenues, Appropriated Surplus and Appropriated Reserves	——
Equals the Real Estate Tax to be Levied	$══

Appropriations, by Funds (Schedule 1)

Appropriations will be listed by Administrative Units, and show a minimum of three objects of expense for each unit, as follows:

100—Personal Services.

200—Equipment.

400—Other Expenses.

Additional objects of expense may be used, if desired by the Budget Officer. Each appropriation should carry the number specified for that administrative unit and object of expense in the Uniform System, and if additional objects are used they should be lettered a, b, c, etc. to indicate that they are sub-objects of the major objects listed.

Estimated Revenues Other than Real Estate Taxes to be Levied, by Funds (Schedule 2)

Estimated revenues other than Real Estate Taxes to be levied will be listed in numerical order, according to the Uniform System of Accounts. These revenues will not include surplus carried forward from the previous year, as that item will be dealt with separately.

The estimates of revenues should be made on a conservative basis, but at the same time they should not be understated in order to provide a hidden reserve. While reserves are useful, they should be provided on a basis which will be disclosed to the public, as later discussed.

Every revenue listed in the Uniform System should be included, if such revenues are collected by the village.

Estimated Cash Surplus at End of Present Fiscal Year (Schedule 3)

This schedule of the Tentative Budget should show the estimated surplus at the end of the fiscal year which will be available for future expenditure. The Village Law requires that this estimated resource be used to finance appropriations of the ensuing year, as hoarding surplus is contrary to the spirit of the law. However, in estimating the surplus which will be available, a deduction should be made for any claims or commitments which will be outstanding at the end of the year. The law provides that purchases made before the end of the year, or services received, may be paid for after the end of the year from the revenues of that year.

Statement of Reserve Funds (Schedule 4)

Certain reserves are permitted by law, namely Reserve for Repairs, Bonded Debt, Tax Stabilization and Workmen's Compensation. The balances of these reserves, which will be represented by cash in special bank accounts, will be stated on an estimated basis in this Schedule. For budget purposes, the Budget Officer may assume that part or all of the reserves will be used to finance appropriations of the ensuing year, or he may assume that the reserves will be carried forward to future years.

In case any part of the existing reserves are recommended for appropriation by the Budget Officer, the amount appropriated will be included in the figures for the administrative unit concerned; and a like amount will be shown in Exhibit A—Summary of Budget, as a deduction from the total appropriations. This, in effect, reduces the amount which must be raised by the tax levy. The appropriation of the reserves is treated in this manner so that the use of the reserves will be clearly brought to the board's and voters' attention during the review of the tentative budget.

Schedule of Salaries and Wages, All Funds (Schedule 5)

The schedule of salaries and wages should include the amounts payable to all employees from all funds, including the electric, gas and steam funds. The schedule should be arranged by administrative units, and should show the rate of compensation, and the amount payable from each fund in parallel columns. Employees with like classifications and annual salary or wages may be included by groups, instead of individually, as follows:

				Distribution	
Class.	No.	Rate	Total	General	Electric
Typist	2	$2100	$4200	$3800	$400

The total of the salary schedule for each administrative unit should tie-in exactly with the appropriation recommended in Schedule 1 of the Budget. This does not apply, of course, to the Electric Fund which is omitted from Schedule 1.

One major salary matter should be considered. In case employees of an administrative unit of the General Fund perform duties for another unit of that fund, the employees should be listed once only, and a footnote added showing the distribution of their salaries within the

Fund. For example, the employees of the Streets and Sanitation Department may be listed in one group, let us assume for a total of $66,000. Below this total would be shown the distribution as follows:

A100—Streets, Administration	$ 2,000
A101—Street Maintenance.	9,100
A125—Refuse Collection ..	44,900
Total	$66,000

In case the Street Department performs services for another department, say the Recreation Department, the estimated charge to that department should be deducted from the $66,000 total shown above, and added to the list of the Recreation Department.

Estimated Electric Utility Operations (Statement 1)

The Village Law requires that the estimated expenses and revenues of the Electric Fund should be shown for information purposes only, as an appendix to the Budget. The operations of this fund do not come within the financial controls established for the budget of other funds, but each village may provide its own method for controlling that fund.

Content of the Budget— Other Considerations

The foregoing discussion concerns itself with the prescribed form of the tentative budget. There are certain considerations regarding the content of the budget which might be considered.

Contingent Fund

It is not possible to foresee every expense of a village, and the law provides that a Contingent Account Appropriation may be made to provide a cushion for such items. The appropriation is limited to 10% of the amounts appropriated excluding debt service and judgments. This is a valuable provision of the law and the amount to be appropriated should be carefully considered. Every village should take advantage of the provision, even though the amount appropriated may be small.

Reserve Funds

Since surplus cannot be accumulated from year to year, many villages feel the need of reserves to guard against heavy expenses in any one year from special contingencies. Reserves for Repairs, Tax Stabilization, etc., may be set aside to provide for the future. Such reserves can be built up little by little over the years, and form a valuable protection against a sudden increase in the tax rate.

Overlay

If all taxes are not collected during the budget year, there will not be sufficient cash to pay the full amount of the appropriations. To guard against this possibility, the Uniform System permits the appropriation of a provision for a reserve for uncollected taxes or "overlay". The appropriation of a reserve based on past collection experience, is advisable in all villages. When such a reserve has been provided, the collection of taxes of prior years should be included in Schedule 2—Estimated Revenues.

Capital Reserves

The use of Capital Reserves to build up funds for future capital projects should be considered, based on long-term programs prepared by the Planning Board or the City Engineer. Such reserves may be accumulated over the years for specific projects, and thus keep the village on a pay-as-you-go basis.

Estimated Assessments

When preparing the budget, it is advisable for the Budget Officer to secure an informal estimate of total assessments from the assessor. While a final figure cannot be obtained, a close estimate is possible. It is not recommended that this estimate be used in any way, except by the Budget Officer in estimating the total appropriations which can be made without increasing the tax rate.

Review and Approval of the Tentative Budget

The review of the tentative budget, the holding of a public hearing on the budget, and the final review and approval of the budget by the Board, need not be referred to here, since this article is concerned principally with the techniques of budget preparation and management.

It is sufficient to point out that the tentative budget as filed with the Village Clerk contains a column headed "Adopted" for the insertion of the final amounts approved by the Board. This avoids retyping, and permits the incorporation of the budget document in the minutes simply by reference. The "Adopted" column need not include amounts for sub-objects of expense, even though included by the Budget Officer for the information of the Board. An illustration of this point is as follows:

A-81 Fire Department

	1953/4	1954/5	Budget Officer's Recommendation	Adopted
400a—Gas & Oil	$3,300	$3,400	$3,500	
400b—Repairs .	1,600	1,600	1,700	
400c—Fuel Oil	200	200	250	
400d—Other ..	1,400	1,500	1,550	
Total 400—Other Expense	$6,500	$6,700	$7,000	$7,000

In this case the amount appropriated is $7,000. The amounts indicated for the sub-objects are considered as memoranda only. However, the Board may give the Budget Officer authority to allocate the total appropriation over the various sub-objects, thus leaving with the Budget Officer the power to make transfers between sub-objects as needed.

Management of the Budget after Adoption

Numerous modifications of the budget may be found necessary after its adoption. Such modifications may be made by the Board under certain restrictions, provided the changes do not upset the balance of the budget.

Transfers

In case all or any part of certain appropriations are not needed, the unexpended balances may be transferred to other appropriations at any time. Good budget practice would require that all requests for transfers should be made by the department heads to the Budget Officer, so that the Board might have his recommendation before acting. Requests for transfers should be reviewed by the Budget Officer as carefully as he reviewed the original budget request.

Excess Revenues

Unforeseen revenues, or revenues collected in excess of estimates, cannot be used for appropriation until the total actual collections plus actual surplus at the end of the year exceed the estimated collections and surplus included in the budget.

Deficiency in Revenues

The budget officer is required to report to the Board whenever, in his opinion, the collection of revenues will fall below the amount estimated in the

budget. The purpose of this note is to permit the Board to review the unexpended balances of appropriations to determine if adjustments can be made to avoid a deficit. While the Board is not required to act, good management would suggest the reduction of appropriations by the amount of the expected deficit.

Contingent Account

In case the budget contains a Contingent Account appropriation, transfers may be made to other appropriations at any time desired by the Board. No expenditures can be made directly from the Contingent Account.

Balance of Reserves

The balances of the Special Reserves for Repairs, Bonded Debt, etc., may be appropriated by the Board at any time during the year. The purpose of the reserves is to provide for contingencies, and they may therefore be used whenever the contingency arises. When such an appropriation is made, it should be added to the appropriations of the administrative unit concerned, as for example A101—Street Maintenance, Objects 100 and 400, for the repair of a major artery of the village. The Appropriated Reserves Account of the double entry system, A590, will be simultaneously increased, so that the budget will remain in balance.

Increase or Decrease in Salaries

Salaries may be increased or decreased during the year by the action of the Board. In villages administered by a Village Manager, this authority may be delegated by the Board to the Manager.

Budget Statements

Monthly statements comparing actual revenues and expenses with the budget are a necessity for the proper management of villages. Since no expenditures in excess of budget appropriations are permitted by the Village Law, it is essential to anticipate any situation which might cause an overrun. A monthly review might also bring to light appropriations which are in excess of requirements. Department heads, as well as the Board, should be kept currently informed as to their budget position.

Management Improvement

Constant study to reduce expenses or to improve services should be made by the budget officer during the year. Almost all local governments can improve their methods of operations, and this management-improvement effort should be headed by the budget officer. He is the one official who has a view of all departments and is in the best position to form judgments regarding their efficiency. He can be of great help to the Mayor or Manager in pointing out improvements in policies, organization and methods.

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Tax Changes Recommended by Commerce and Industry Association of New York

Franchise Tax Recommendations

The present statute of limitations on assessments for Article 9A companies is five years. It is suggested that this be reduced.

Under the present law a corporation on a fiscal-year basis must file its return within three and one-half months after the close of the fiscal year. This association proposes that the due date be extended to four and one-half months.

Net operating losses are not allowed as a deduction in determining entire net income. The association would like to introduce the concept of net operating loss carryovers and carrybacks.

BENJAMIN HARROW, C.P.A., *has been a member of our Society since 1928, and a member of the American Institute of Accountants since 1922. He is a member of the New York Bar and Professor of Law at St. John's University.*

Mr. Harrow is a past Vice-President of the Society. He is a member of the Society's Committees on Meetings and Committee Operations, and has served for a number of years on the Institute's Committee on Federal Taxation.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

A real estate corporation loses its status as an Article 9 corporation if its investment in securities exceeds 10% of gross assets. The association suggests that a corporation be allowed to retain its status as a real estate corporation when its investment in securities exceeds the 10% limitation through the sale of its property, provided it reacquires its classification within a specified time.

In determining the 10% limitation, treasury stock is included as an investment in securities. It is proposed to eliminate this requirement.

Article 9 corporations must file returns by March 1. The association proposes that the date be extended to May 15.

In a merger of two or more real estate corporations, an additional tax of 2% is payable on the surplus. For example, Corporation X owns all the stock of Corporation Y. Both corporations are real estate companies. Corporation Y dissolves and transfers its assets to Corporation X. Not only is a 2% tax payable on the surplus of Corporation Y upon the distribution, but the surplus will be determined by taking the fair market value of the assets of Corporation Y as of the date of dissolution. For example, suppose Corporation Y has a book deficit of $30,000 at the date of

dissolution. Suppose the assessed value of the real estate exceeds the book value by $40,000. Since the assessed value will be presumed to be equal at least to the fair market value, Corporation Y is deemed to have a surplus of $10,000 and upon dissolution a tax of $200 will be payable. The association suggests that this requirement be eliminated.

Personal Income Tax Recommendations

The optional standard deduction of 10% or $500, whichever is less, is allowed in lieu of all deductions including trade and business expenses. The association recommends that the optional standard deduction be allowed in lieu only of personal deductions, thus allowing trade and business expenses in addition. In our opinion that was the intention of the legislature when the optional standard deduction was first introduced in 1947.

Self-employed taxpayers are unable to take advantage of the provision allowing a deduction for contributions made to an employees-retirement plan. The association is proposing that such taxpayers be allowed a deduction in relation to a retirement plan for themselves, probably similar to the Jenkins-Keogh bills under the Federal law.

Perennially the proposal is made to simplify the State income tax law by adopting Federal net income or adjusted gross income as the basis of the New York tax. This of course would have to be subject to specific statutory adjustments.

The association is also suggesting conformity to the Federal law in areas where there now are differences. The Federal law allows a deduction of 20% of adjusted gross income for charitable contributions, with an additional 10% for contributions to a church, an educational organization or a hospital. Under State law the contributions may not exceed 15% of net income.

Under Federal law, a gain on sale of a residence is not recognized if a new residence is acquired within one year before the sale and one year after the sale. Under New York law the period is six months.

Under Federal law, a lump sum distribution under a stock-bonus, pension or profit-sharing plan may be treated as a capital gain. Under New York law such amounts are ordinary income.

Income from annuities is taxed differently under both laws. Under Federal law, only that part of each annuity is taxable, which represents the excess of the expected return over the amount invested. Under State law, 3% of the consideration paid is taxable on each annuity, until the sum of the non-taxable amounts reaches the consideration paid, after which the entire annuities are taxable.

Under Federal law, real estate taxes on a sale of property may now be apportioned between buyer and seller. Under State law the former Federal law is still in effect. Only the person liable for the tax may take the deduction.

Accounting at the SEC

Conducted by LOUIS H. RAPPAPORT, C.P.A.

Twenty-Second Annual Report
Fiscal Year Ended June 30, 1956
Securities and Exchange Commission

A Reprint of the Section Dealing with the Activities of the Commission in Accounting and Auditing

The several acts administered by the Commission provide that dependable, informative financial statements, which disclose the financial status and earnings history and potentialities of a corporation or other commercial entity, shall be made a part of registration statements, applications for registration, and periodic reports required to be filed with the Commission. These financial statements are always a vital, often the most significant, element of the information the investor must have upon which to predicate investment decisions.

The Congress recognized the importance of these statements. It was aware also that they lend themselves readily to misleading inferences or even deception, whether or not intended. Consequently, the various statutes administered by the Commission deal extensively with financial statement presentation and the accounting concepts and principles on which they are based. The recognition by the Congress that accountants and accounting perform a vital role in achieving the statutory objectives of fair disclosure, prevention of fraud, inequitable and unfair practices, and control and regulation, makes the activities of the Commission in the field of accounting most significant from the standpoint of the investor.

Thus, for example, the Securities Act requires the inclusion in prospectuses of balance sheets and profit and loss data "in such form as the Commission shall prescribe,"[1] and authorizes the Commission to prescribe "the items or details to be shown in the balance sheet and earnings statement, and the methods to be followed in the preparation of accounts * * *."[2] Similar authority is contained in the Securities Exchange Act,[3] and more comprehensive power is embodied in the Investment Company Act[4] and the Holding Company Act.[5]

The Securities Act provides that the financial statements required to be made available to the public through filing with the Commission shall be certified by "an independent public or certified accountant."[6] The other three statutes permit the Commission to require that such statements be accompanied by a certificate of an independent public ac-

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LOUIS H. RAPPAPORT, C.P.A., *a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A.s, is the author of* SEC Accounting Practice and Procedure.

countant,[7] and the Commission's rules require, with minor exceptions, that they be so certified. The value of certification by qualified accountants has been conceded for many years, but the requirement as to independence, long recognized and adhered to by some individual accountants, was for the first time authoritatively and explicitly introduced into law in 1933. Out of this initial provision in the Securities Act and the rules promulgated by the Commission,[8] together with strict action taken by the Commission in certain cases,[9] there have grown concepts of accountant-client relationship that have strengthened the protection afforded investors.

The Commission's standards of independence are stated in rules 2–01 (b) and (c) of regulation S–X which provide among other things that an accountant will not be considered independent with respect to any person, or any affiliate thereof, for any period during which he has any financial interest, direct or indirect, in such person, or with whom he is or as connected was a promoter, underwriter, voting trustee, director, officer or employee. In determining whether an accountant is in fact independent with respect to a particular registrant, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that registrant or any affiliate thereof.

Experience with these rules shows that many accountants, especially those certifying financial statements of companies coming within the Commission's jurisdiction for the first time by reason of a registration statement for a new issue or the listing of an outstanding issue on an exchange, find that they cannot certify financial statements of clients of long standing because during the period for which financial data is required to be furnished they have served clients of whom they have in fact not been independent. The most common (and often unwitting) cause of lack of independence is ownership of stock by a member of the accounting firm of the client company during any of the periods certified. This the Commission deems an absolute bar to independence, though exceptions where there would be particular hardship and investor protection can be achieved by other safeguards, have occasionally been permitted.

As shown above, the statutes administered by the Commission give it broad rule-making power with respect to the preparation and presentation of financial statements. Pursuant to the authority contained in the statutes the Commission has prescribed uniform systems of accounts for companies subject to the provisions of the Holding Company Act;[10] has adopted rules under the Securities Exchange Act governing accounting and auditing of securities brokers and dealers; and has promulgated rules contained in a single, comprehensive regulation, identified as Regulation S–X,[11] which govern the form and content of financial statements filed in compliance with the various acts. This regulation is implemented by the Commission's Accounting Series releases, of which 77 have so far been issued. These releases were inaugurated in 1937, and were designed as a program for making public, from time to time, opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions. The rules and regulations thus established, except for the uniform systems of accounts, prescribe the accounting to be followed only in certain basic respects. In the large area not covered

by such rules the Commission's principal reliance for the protection of investors is on the determination and application of accounting principles and standards which are recognized as sound and which have attained general acceptance.

Changes and new developments in financial and economic conditions affect the operations and financial status of the several thousand commercial and industrial companies required to file statements with the Commission. It is necessary for the Commission to be informed of the changes and new developments in these fields and to make certain that the effects thereof are properly reported to investors. The Commission's accounting staff, therefore, engages in study designed to establish and maintain appropriate accounting procedures and practices. The primary responsibility for this program rests with the chief accountant of the Commission who has general supervision with respect to accounting and auditing policies and their application.

Furtherance of these activities requires constant contact and cooperation between the staff and accountants both individually and through such representative groups as, among others, the American Accounting Association, the American Institute of Accountants, the American Petroleum Institute, the Controllers Institute of America, the National Association of Railroad and Utilities Commissioners, and National Federation of Financial Analysts Societies as well as other governmental agencies. Recognizing the importance of cooperation in the formulation of accounting principles and practices and proper auditing procedures which will best serve the interests of investors, the American Institute of Accountants and the Controllers Institute of America regularly appoint committees which maintain liaison with the Commission's staff.

For example, experience over the years has shown the need for an adequate guide for the auditing of broker-dealers who are required to file reports on Form X–17A–5 with the Commission, under rule X–17A–5. These reports include responses to a financial questionnaire and supplementary questions. Our rules now prescribe what are referred to as "Minimum Audit Requirements." Examination of the reports seems to indicate that many accountants consider these to be all of the requirements and fail to vary their procedures to fit changing conditions. Our chief accountant has been cooperating for some time with committees of the American Institute of Accountants in an effort to produce a comprehensive guide in this specialized field of auditing. This work resulted in the publication by the American Institute of Accountants, under date of October 24, 1956, of a booklet entitled: "Audits of Brokers or Dealers in Securities." It is expected that Form X–17A–5 will be appropriately amended.

The many daily decisions of the Commission require the almost constant attention of some of the chief accountant's staff. These include questions raised by each of the operating divisions of the Commission, the regional offices and the Commission. This day-to-day activity of the Commission and the need to keep abreast of current accounting problems causes the chief accountant's staff to spend much time in the examination and reexamination of sound and generally accepted accounting and auditing principles and practices. From time to time members of this staff are called upon to assist in field investigations, to participate in hearings, and to review opinions insofar as they pertain to accounting matters.

Prefiling and other conferences, in person or by phone, with officials of corporations, practicing accountants and others occupy a considerable amount of the available time of the staff. This procedure, which has proved to be one of the most important functions of the office of the chief accountant, and of the chief account of the Division of Corporation Finance and his staff saves registrants and their representatives both time and expense.

Many specific accounting and auditing problems arise as a result of the examination of financial statements required to be filed with the Commission. Where examination reveals that the rules and regulations of the Commmission have not been complied with or that applicable sound accounting principles have not been adhered to, the examining division usually notifies the registrant by an informal letter of comment. These letters of comment and the correspondence or conferences that follow continue, as in the past, to be a most convenient and satisfactory method of effecting corrections and improvements in financial statements, both to registrants and to the Commission's staff. Where particularly difficult or novel questions arise, which cannot be settled by the accounting staff of the divisions and by the chief accountant, they are referred to the Commission for consideration and decision. The Commission's treatment of accounting questions by these administrative means is extensive. A considerable portion of the time of the accounting staff is spent in the discussion of such cases by letter and telephone, and in conference with registrants and their accounting and legal advisers. There is also a large, and in recent years growing, volume of inquiries as to the propriety of particular accounting practices from accountants and from companies not presently subject to any of the acts administered by the Commission who wish to have the benefit of the Commission's views, and thus utilize and apply the Commission's experience to the facts of their own case.

During 1956 several accounting problems required the staff's consideration, some for the first time because of new economic developments and others due to changed viewpoints. The past year has seen an increasingly large number and variety of corporate mergers and acquisitions, and many more reportedly are in process. Since the transactions occurring in this area of business activity may have material effect upon the reported earnings of the corporations involved as well as serious tax consquences, it is essential that sound and workable criteria be established governing the accounting therefor. The Commission's staff has been cooperating closely with the accounting profession to bring about the establishment of uniform procedures in this area.

Novel accounting problems have been raised in connection with a public offering by a corporation organized under the laws of the District of Columbia pertaining to the incorporation of insurance companies, of contracts described as "variable annuity contracts." These contracts are discussed in greater detail on pages 190, 192 of this report. While proposals have also been made in other jurisdictions for the issuance of this type of contract, this case is the only one thus far presented to the Commission for its consideration. This form of contract differs from the conventional annuity contract usually available from insurance companies in that the issuer is not obligated to pay a fixed dollar amount but instead contracts to pay varying periodic sums depending upon the value of an underlying fund invested in common stocks and other equity

securities. The appropriate accounting for these contracts is receiving the attention of the Commission's staff in cooperation with the accounting profession.

References

1. Sec. 10 (a) (1) (Schedule A, pars. 25, 26).
2. Sec. 19 (a).
3. Sec. 13 (b).
4. Secs. 30, 31.
5. Secs. 14, 15.
6. Sec. 10 (a) (1) (schedule A, pars. 25, 26).
7. Securities Exchange Act, sec. 13 (a) (2); Investment Co. Act, sec. 30 (e); Holding Company Act, sec. 14.
8. See, for example, rule 2-01 of regulation S-X.
9. See, for example, Securities Exchange Act Release No. 3073 (1941); 10 S. E. C. 982 1942; and Accounting Series Release No. 68 (1949).
10. *Uniform System of Accounts for Mutual Service Companies and Subsidiary Service Companies* (effective August 1, 1936); *Uniform System of Accounts for Public Utility Holding Companies* (effective January 1, 1937; amended effective January 1, 1943).
11. Adopted February 21, 1940 (Accounting Series Release No. 12; revised December 20, 1950 (Accounting Series Release No. 70).

On Goodwill

. . . the term "goodwill" has often been too loosely used. In some cases it appears to represent no more than a balancing of the difference between the cost of assets acquired and the par or stated value of capital stock issued therefor. In other cases it apparently represents amounts which might properly have been segregated and charged to a more specific tangible or intangible asset account. Deficiencies have been cited wherever the evidence available indicates that such practices have been followed in setting up a charge for purchased goodwill. . . .

There has also been wide diversity in the accounting policies followed by registrants with respect to the amortization or write-off of goodwill. Accountants and registrants frequently have contended that goodwill may be permanently retained at cost in the balance sheet regardless of apparent impairment of value. However, deficiencies have been cited throughout the period under discussion on the ground that goodwill is no different in this respect from any other asset, and if a permanent impairment of its value exists then appropriate provision should be made in the accounts to record the loss. . . .

The Commission has adopted no general rule as to the amortization of goodwill. However, in those cases in which a registrant has retained "goodwill" indefinitely in its accounts, the staff has inquired into the propriety of this accounting treatment. As a result of an analysis of the nature of the account a number of registrants have undertaken programs of amortization which will result in charging the goodwill to income or, in some cases, earned surplus, over a reasonable number of years.

from the chapter on "Requirements of the SEC,"
CONTEMPORARY ACCOUNTING, *the American Institute of Accountants, 1945.*

Administration of a CPA Practice

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by Max Block, C.P.A.

Fees and Personalities . . . New York State Tax Reduction Problem . . . Engagement Time Estimate Forms.

Fees and Personalities

A good deal has been written and spoken about fees but some areas are as yet inadequately explored. It is basic that time and type of personnel utilized underlie fee determinations. But the intangible factors that influence per diem rates, fixed amount retainers, and special engagement fees can have a significant effect on the amounts finally agreed to by clients. Intangibles such as status of the firm or practitioner, experience, and competence are obviously influences of no small importance. But the final intangible is that of the personality composition of the fee negotiator. It is in this area that additional inquiry and publicity are very desirable.

Salesmanship, perhaps a non-professional term, is the ingredient that accounts for substantial fee differences where all other factors may be of equal value. The composition of salesmanship is a number of intangibles, such as self-confidence, strong nerves, intuitive ability to recognize the proper approach, ability to impress and convince a prospect, alertness to opportunities to bring out values and achievements, personal impressiveness, demonstrable competence, etc., etc.

It isn't ordinarily possible for competent accountants who are possessed of excessive humility, or have feelings of insecurity, or who have no salesmanship instincts, to be able to negotiate the best fee arrangements. Fee negotiations, to an important extent, require the same native shrewdness as accounts for success in business. Though accountancy is a profession, it nevertheless has business aspects. Getting the best possible fees, and efficiency and economy of operations have as much place in our profession as in business. Obviously, fees have a definite relationship to what is furnished the client, but there is no one-price tag on personal services.

Can a man overcome the personality traits that keep him from doing a good selling job? Improvement is possible.

Max Block, C.P.A. *(N.Y., Pa.) is a former chairman of the Committee on Administration of Accountant's Practice of the New York State Society of Certified Public Accountants. He is a lecturer at The City College of New York in the graduate course on Accounting Practice. Mr. Block is a member of the firm of Anchin, Block & Anchin.*

The extent of improvement depends on these factors:

1. Honest self-appraisal and a listing of weak points that require bolstering.
2. Discussion of these aspects with one qualified to make valid suggestions for improvement.
3. Observance of the procedures of one who is a successful fee negotiator.
4. Diligent application to the procedures adopted and observance of results achieved.
5. Improved preparation for entry into a fee negotiation session.

There undoubtedly are instances where it would be very wise for an accountant to turn over fee negotiations to a partner who is more adept. There should be no loss of pride or position in such cases, handled tactfully, because it is common knowledge that characteristics are unevenly spread. The extrovert has redeeming qualities, and the introvert also has them.

New York State Tax Reduction Problem

New York accountants recall the very difficult problem that was created a year ago by the dilatory tactics of the State Legislature in dealing with the proposed income tax reduction. Many accountants delayed the mailing of state tax returns as long as they felt they could and then sent them out without credit for the pending reduction, merely advising taxpayers of the existing situation. As a consequence, there was a flood of calls from taxpayers inquiring about the reduction, refunds, etc. Others had different difficulties dependent on the courses they followed.

At this writing a repetition of last year's experience appears possible. Therefore, it behooves us to try to avoid last year's confusion by very practical methods. A practical course is that state tax returns be sent to taxpayers as quickly as prepared. Accompanying each return should be a letter setting forth, as a minimum, the following points:

1. An income tax reduction, of a maximum amount of $35, is under consideration, by the Legislature, but there is no way of telling when, if at all, such law will be passed.
2. If the reduction materializes after a tax return has been filed, taxpayers will automatically receive refunds, without having to request them, and that such refunds will be made reasonably promptly.
3. If, by the time such a communication is prepared, the tax reduction formula appears definite it might be incorporated in the letter with instructions to taxpayers as to how to compute and record the reductions themselves.

By this process accountants should be relieved of most of the confusion and strain that occurred last year.

Engagement Time Estimate Forms

Accountants can use engagement time estimate forms as helpfully as their clients use cost and sales price estimate forms. The objectives are essentially the same.

A time budget form will facilitate the determination of time requirements and fee estimates, and, in the aggregate, help check total staff adequacy. Actual engagement time can be compared with estimates for whatever morals can be drawn therefrom. It is a practical form that can move between persons for review and discussion.

The form should list all categories of personnel that enter into the cost determinations. This could include partners' time as well as that of office review, typing, and proofreading. Columns can be arranged to disclose current year's estimate, prior year's actual, and such other columnar data as is desirable in an individual case. One may consider it helpful to make provision for specific functions, such as confirmation time and inventory time, if such highlighting will insure more adequate consideration.

Time estimate forms can be useful for annual audits and for interim audits as well. Notes can be appended for future consideration that may be helpful in making up each year's time estimate. There undoubtedly are many instances in which staff members can be very helpful in the estimating process and a column could be provided for that purpose.

Dollar valuations, in a column therefor, will provide the basis for quoting fixed retainer fees. If the valuation is on a cost basis, margin must be added. If the valuation is on a billable basis, the columnar total could be the basis for the estimate.

Practitioners who are using such forms are requested to submit copies and comments as to experience to the editor of this department for future review.

Sending Information To Clients

One means of evidencing an interest in the client's affairs, which is used not infrequently by certified public accountants, is to send to clients information which the practitioner believes would be of interest to them. The Rules of Professional Conduct prohibiting advertising and solicitation do not impede the sending of legitimate information to clients; for example, reprints of articles from professional journals, or speeches, or pamphlets prepared by the American Institute of Accountants or other professional societies which might be helpful or interesting to the client concerned.

It is considered preferable to send such material with a personal note. Stamping of the name of the certified public accountant on the material itself is not regarded with favor. If any doubt is possible, the source of the material should be made known.

To send to the client desk calendars, desk blotters, or other articles which are not informative but are clearly intended for display in the client's office, and which bear the name of the certified public accountant or firm who sent them, might be considered a violation of [the AIA's] Rule Number 10.

from PROFESSIONAL ETHICS OF CERTIFIED PUBLIC ACCOUNTANTS *by John L. Carey, the American Institute of Accountants, 1956.*

Payroll Tax Notes

Conducted by SAMUEL S. RESS

Pending Legislation . . . Payment of Subsidiary Contributions . . . Taxable Wages . . . Extension of Coverage to Employers of One or More Employees . . . Coverage of Non-profit Organizations . . . Proposed Repeal of Hughes-Brees Merit Rating Tax System . . . Other Unemployment Insurance Proposals . . . State Minimum Wage Law Proposals . . . Labor Welfare Funds.

Pending Legislation

Legislation is of special interest to certified public accountants, especially those measures which contain retroactive features dealing with various tax levies. Other forms of regulation of business affect business operations and ultimately the financial reports which the accountant must prepare for his client.

There have been introduced in the New York State Legislature a number of bills which would amend the social insurance program of employers in this state. To the accountant, the words *social insurance program* mean new payroll taxes or fringe benefits reflecting additional payroll costs for which provision must be made. Sometimes the proposed legislation may result in tax savings or reduced payroll costs. Of course when these occur, the accountant should be prepared to take advantage of them for the benefit of his client.

With these preliminary thoughts, and with a special caution that what follows is legislation that has been proposed for enactment but has not yet been enacted as of the date of this article, we report on bills introduced affecting payroll taxation and payrolls of New York employers.

Unemployment Insurance—Payment of Subsidiary Contributions

The law at present provides that when the balance in the general account of the Unemployment Insurance Fund on June 30th of any year is less than 1.5 percent of the total payrolls in the preceding calendar year, all employers who have been subject to the law for at least five completed calendar quarters before June 30th are required to pay

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Dr. Ress is a member of the Society's Committee on New York State Taxation and Chairman of its Subcommittee on Unemployment Insurance.

subsidiary contributions in the following year. On June 30th, 1956 the balance in the General Account was less than the stipulated 1.5 percent of payrolls, so that, under present provisions of the law, employers will be required to pay a subsidiary tax on their payrolls commencing January 1, 1957 of 0.3 percent.

The Administration has sponsored a bill to provide that the subsidiary contribution would be imposed when the balance is less than 1.0 percent of payrolls instead of 1.5 percent, retroactive to June 30th, 1956. If enacted, this proposed amendment to section 577 (5) of the Unemployment Insurance Law would wipe out the present increased unemployment insurance tax of 0.3 percent on employers' taxable payrolls for the year 1957. Unless this amendment to the Unemployment Insurance Law is passed the State will collect from New York employers $39,000,000.

Taxable Wages

At present an employer is required to pay unemployment insurance taxes only on the first $3000 of an employee's earnings during the calendar year.

Three bills have been introduced to increase the amount of each employee's taxable wages subject to the payment of unemployment insurance taxes. One measure would increase to $3600 the amount of taxable wages. Another bill would raise the taxable wage base to $4200, the same amount of wages as is presently subject to the Federal Insurance Contributions Act for social security. The third measure raises taxable annual wages for unemployment insurance to $4500. The change would be made by amending section 518 (1) of the law.

Extension of Coverage to Employers of One or More Employees

Since the beginning of this year employers having two or more workers on any day are liable for unemployment insurance taxes. Domestic workers are considered separately from an employer's other employees and an employer becomes liable for taxes with respect to his domestic servants only if he employs four or more domestics on any day.

A bill sponsored by the Administration provides that employers of one or more employees on any day would be liable for unemployment insurance taxes. Domestic workers would continue to be considered separately as heretofore.

Coverage of Non-profit Organizations

Under present law, non-profit religious, charitable, scientific, literary, or educational organizations are not liable for unemployment insurance taxes except with respect to persons employed temporarily and solely for construction, or for the production of theatrical performances. Such organizations may voluntarily elect to be covered under the present law.

A proposed amendment to section 560 (4) of the Law would remove the exemption and extend complusory coverage to these types of non-profit organizations.

Proposed Repeal of Hughes-Brees Merit Rating Tax System

The Hughes-Brees bill was enacted in 1951. It established the present system of providing reduced tax rates for employers who have stable employment records. A bill has been introduced to repeal the merit-rating provisions of the Hughes-Brees law. Other measures are

presently contemplated which would make important changes in the rating provisions of the law. These proposed changes are designed to permit the imposition of higher tax rates than are permitted presently on certain industries or employers whose benefit experience record has been extremely poor in that much more in benefits have been paid to their former employees than had been collected in unemployment insurance contributions. Another amendment is designed to facilitate pooling of industrial experience for unemployment insurance rating purposes.

Other Unemployment Insurance Proposals

Bills have been introduced to raise the maximum benefit rate from the present \$36 to \$45 or to \$50 per week with further allowances of \$4 additional for each dependent up to 3 dependents.

One bill would change the eligibility requirement for benefits to 15 weeks employment with average earnings of \$15 a week, instead of the present requirement of 20 weeks with average earnings of \$15 a week. Another bill would reduce the requirement to employment in 15 weeks but increase the required earnings to an average of at least \$20 a week.

State Minimum Wage Law Proposals

The ten state minimum wage orders now in effect in New York indirectly apply to men because of the provision of the law which states that in order to protect the standards of women and minors who are covered directly by the state minimum wage law, no man shall be employed in an occupation at wage standards less than those fixed in a minimum wage order for women and minors in such occupation.

A bill sponsored by the Administration would cover men directly. The public policy of the State would be amended to provide that all employees, not only women and minors, shall receive wages sufficient to provide adequate maintenance. Wage boards would have direct jurisdiction over minimum wage standards for men, and in making its recommendations the board would consider the cost of living, value of services, and wages paid for comparable work of men as well as women and minors. The bill provides that as a public policy, minimum wage standards shall be maintained at and adjusted as rapidly as possible to levels consistent with the health, efficiency and well-being of all employees. Executives, administrators, and professionals would not be covered.

Another proposal would require that no State minimum wage order could establish a minimum rate of less than \$1.25 an hour.

Labor Welfare Funds

A 1956 enactment provided for the regulation of employee welfare funds that are established or maintained jointly by employers and unions. Trustees of such funds are required to register with the State Insurance or Banking Department and file annual statements and reports on the operation of the fund and on matters requested by the Insurance or Banking Department. A bill would extend the application of the law to funds established or maintained by one or more employers even though there is no union involved.

Another measure would amend the Labor Law by making it a misdemeanor for an employer to wilfully fail to make agreed payments to a health and welfare fund.

Federal Income Tax Notes

Conducted by RICHARD S. HELSTEIN, C.P.A.

Casualty Losses . . . How to Turn a Capital Expenditure Into a Business Deduction . . . A Case Under Sec. 722 With Broad Implications . . . Rulings re: Employees' Trusts . . . Dealer Reserve . . . Partner's Guaranteed Payments . . . Error in Tax Form.

Casualty Losses

The "proposed regulations" on casualty losses have been attacked even before they have been adopted. Proposed Regulations Sec. 1.165-3(c) distinguishes between the amount deductible for casualty loss of business property as opposed to non-business property—to the detriment of the former.

In Example 2 of the Regulations, based on the parenthetical facts (basis: $20,000; market value before casualty: $30,000; after casualty: $18,000), the owner of non-business property has a deductible loss of $12,000, while the owner of business property would be allowed only $8,000.

RICHARD S. HELSTEIN, C.P.A., *has been a member of our Society since 1940. He has been a member of the Committee on Federal Taxation, as well as various other committees. He is presently a member of the Committee on Publications.*

Mr. Helstein has contributed to accounting and other publications, and delivered addresses before our Society and other professional societies. He is associated with J. K. Lasser & Company.

This results from the application of the Commissioner's formula for computation of casualty loss on business property, which has been in effect since 1929 (G.C.M. 6122, VIII-2 CB 115). Under this formula, the deductible loss is the proportion of the adjusted basis which the value of the destroyed property bears to the value of the entire property.

This formula has been used in a number of Tax Court cases without ever having been contested by a taxpayer or commented upon by the Court.

After the hurricanes of 1954 the Service issued IRS Publication No. 155 explaining how casualty loss deductions were to be computed and distinguishing between business and non-business property.

Originally the Commissioner applied the formula to all property. However, in *Helvering* v. *Owens*, (305 U. S. 468, 1939), which involved property *not* used in a trade or business, the Supreme Court denied the formula and held the entire loss of value was deductible (limited, of course, to the basis of the property).

Because of this decision, the Commissioner has accepted the distinction as evidenced in his "proposed regulation".

The Fifth Circuit has now held that there is no basis in law for the Commissioner's "formula" in the case of business property, and, in a most interesting opinion, has decided that the full loss in value is deductible in the case of business property as well as non-business property. (*Alcoma Association Inc.* v. *U. S.*, C.A.-5, 11/30/56 rev'g D.C.).

If returns were filed pursuant to the Service's formula for the computation of deductible loss on business property, it might be advisable to file protective claims for refund for any open years until the method of treatment is finally determined.

How to Turn a Capital Expenditure Into a Business Deduction

Sec. 23(a)(1)(A) IRC 1939 and Sec. 162(a)(3) IRC 1954 provide that where "rental payments" are applied against the purchase price of occupied property, the applied portion is not deductible as ordinary business expense. Here is a company which was able to do so with the approval of the Tax Court.

A parent corporation signed a ten-year lease with a non-related lessor, at a rental of $1,000 per month. The lease contained the option to purchase, and provided that if the option were executed, one-half of the rent paid would be applied against the purchase price.

The parent allowed its subsidiary to occupy the plant. The subsidiary paid the rent directly to the landlord. The business of the subsidiary was the manufacture of a product which was sold exclusively to the parent company. For each of the years in litigation, the subsidiary suffered a net operating loss which was caused, in part, by a deduction of the rent paid. The parent reimbursed the subsidiary for the full amount of its net operating losses on the basis that the product it purchased from the subsidiary was underpriced. Thus the parent took a full deduction for the rent paid in its reimbursement to the subsidiary of the net operating losses.

The Commissioner disallowed one-half the rent deduction to the subsidiary, and disallowed as a deduction to the parent the reimbursement of the subsidiary's net operating losses.

The Court held that the total amount of the rent was deductible by the subsidiary since the lease with its option was not assigned by the parent and that therefore the subsidiary had no equity in the property by virtue of the rental payments. It further allowed as an ordinary business expense the reimbursement by the parent of the subsidiary's net operating losses on the grounds that the payments were made either as an adjustment in the price of the products the subsidiary sold to the parent, or to insure a continued supply of such products. (*Fishing Tackle Products Co.*, 27 TC _____ No. 73.)

A Case Under Sec. 722 With Broad Implications.

With a few notable exceptions, the IRS has honored its Commissioner's rulings as a matter of public relations and, we presume, to avoid financial chaos in business planning.

In a recent case (*Standard Hosiery Mills, Inc.* 27 TC _____ No. 58) the Service has ignored the "express permission" granted by the Commissioner to a taxpayer to "use" Sec. 722 relief allowed and "finally determined" for a prior year, on a subsequent year's return, and has been upheld by the Tax Court.

The Commissioner's ruling was based upon the Committee Reports, the Law

and the Regulations. The Court held, however, that the right was merely one of administrative expediency, and not a "substantive right" to the relief.

The taxpayer, in reliance upon the Commissioner's letter, failed to preserve the records upon which its relief was based in the prior taxable year, and therefore was unable to support its claim when the subsequent year was examined.

With respect to this latter point, the Court held that the taxpayer's argument of "equitable estoppel" was "without merit".

The implications of this case go far beyond Sec. 722. Is a net operating loss, the amount of which has been determined by examination, to be vulnerable for re-examination in each year to which it is carried? Is a transaction, ruled to be an installment sale, taxable at capital gain rates, perennially susceptible? The possibilities extend to any transaction, the effects of which affect subsequent taxable years.

Rulings re: Employees' Trusts

The Treasury interprets Sec. 1.410-1(b)(I)(ii) as providing that the distributions from a qualified employee's profit-sharing plan be "distributed to the employee", and that "payments to others should be merely incidental as, for example, in a joint and survivor annuity contract, or where an unused balance in the account of the employee is paid to a beneficiary upon the death of an employee". It has therefore ruled that any pension, stock-bonus or profit-sharing plan which permits a participant to irrevocably elect, prior to his retirement, to have all or a part of his nonforfeitable interest in the plan, which would otherwise become available to him during his lifetime, paid only to his designated beneficiary after his death, will fail to meet the requirements of Sec. 401(a) for exemption under Sec. 501(a) IRC 1954. (Rev. Rul. 56-656 IRB 1956-51,13)

The Commissioner has held in another ruling that employees' pension trusts which otherwise qualify for exemption under Sec. 401(a) IRC 1954, will not qualify if they contain a provision that the participants, prior to any severance of their employment, or prior to the termination of the plan, may withdraw all or a part of the funds accumulated on their behalf because of financial or other emergency. The Commissioner reasons that the provisions which allow disability or death benefits prior to severance or termination of the plan are merely "incidental to the main purpose of the plan". He holds, however, that such a provision in a *profit-sharing* plan would not of itself prevent qualification. (Rev. Rul. 56-693, IRB 1956-52,13)

Sec. 503(c), which defines "Prohibited Transactions" which may cause denial of exemption to employee profit-sharing, pension or stock-bonus plans, and Sec. 501(e)(3) organizations, includes the loan, directly or indirectly, to its creator, of "any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest".

The "Proposed Regulations" under this section included as such *loans*, the holding of the creator company's debentures after January 31, 1957, which were purchased prior to November 9, 1956. Announcement of this was made in *Technical Information Release No. 27* (11/8/56) in order to allow time for any affected exempt organizations to dispose of such holdings.

Because of testimony at the hearings on the proposed regulations before the

House Ways and Means Committee, it was determined that this provision needed further study by the Committee and by Congress.

To avoid unwonted hardship upon the holders of such debentures, the date for application of the strictures of this section was extended from January 31, 1957 to June 30, 1957 (*Technical Information Release No. 35*, 1/2/57).

Dealer Reserve

A "Dealers Reserve" account was credited by a finance company with 5% of the selling price of the trailers, the installment sales contracts of which were assigned to it by the taxpayer, a dealer. The other 95% was paid to the taxpayer in cash. Since the taxpayer guaranteed the contracts, the 5% was used as a reserve against any defaults, and no portion of it was payable to the taxpayer until the balance in the "Dealers Reserve Account" exceeded 15% of the balance due on all contracts assigned.

The accrual basis taxpayer excluded the balance in the "Dealer Reserve Account" from income at the close of its fiscal year.

The Tax Court ruled that the taxpayer was wrong. It reasoned that the sale was for the full price and must be reported as such. The reserve of 5% could only be a deduction, but since such deduction was "contingent" at the end of the fiscal year, income could not be reduced. It was further held that the taxpayer did not establish that 5% was a reasonable addition in amount to a Reserve for Bad Debts.

The Court comments that its holding in a similar case was reversed by Circuit Court (*Blaine Johnson*, CA-4, 1956, 233 F (2d) 952 rev'g. 25 TC 123) but reiterates its position after "carefully re-examining the question involved". (*Texas Trailercoach, Inc.*, 27 TC ____ No. 64)

The Commissioner has adopted this position in Rev. Rul. 57-2 (IRB 1957-1, 12). Charges to the Dealers Reserve by banks or finance companies because of worthless notes are to be taken as bad debts when they arise.

Partner's Guaranteed Payments

Where a partnership has a net loss on operations for its fiscal year resulting from the deduction of guaranteed payments under Sec. 707(c) IRC 1954, the partner receiving the guaranteed payments must include such payments in gross income for purposes of income tax.

In computing the self-employment tax, he must net such payments against his distributive share of the partnership loss. Where there is a profit, self-employment income is the aggregate amount of the guaranteed payments and the distributive share of the profits. (Rev. Rul. 56-675, IRB 1956-52, 17)

Error in Tax Form

There is an error in Federal Tax Form 1065. The reference to line 26 on line 1, page 4, Schedule N, Partnership Return, should be to line 16. (IRS Notice, IRB 1956-49, 34)

Official Decisions and Releases

Accounting Research Bulletin No. 47: Accounting for Costs of Pension Plans

Issued by the AIA's Committee on Accounting Procedure, September 1956

1. Variations in the provisions of pension plans in the United States, in their financial arrangements, and in the circumstances attendant upon their adoption, have resulted in substantial differences in accounting for pension costs. This bulletin indicates guides which, in the opinion of the committee, are acceptable for dealing with costs of pension plans in the accounts and reports of companies having such plans. It is not concerned with funding as such.

2. The term *pension plan* is here intended to mean a formal arrangement for employee retirement benefits, whether established unilaterally or through negotiation, by which commitments, specific or implied, have been made which can be used as the basis for estimating costs. It does not include profit-sharing plans or deferred-compensation contracts with individuals. It does not apply to informal arrangements by which voluntary payments are made to retire employees, usually in amounts fixed at or about the time of an employee's retirement and in the light of his then situation but subject to change or discontinuance at the employer's will; where such informal arrangements exist, the pay-as-you-go method of accounting for pension costs generally is appropriate, although the accrual method is equally appropriate in cases where costs can be estimated with reasonable accuracy.

3. When a pension plan is first adopted, it is customary to provide that pensions for covered employees will give recognition not only to services which are to be rendered by them in the future, but also to services which have been rendered by them prior to the adoption of the plan. The costs of the pensions to the employer, therefore, usually are based in part on past services and in part on current and future services of the employees. The committee considers that all of such costs are costs of doing business, incurred in contemplation of present and future benefits, as are other employment costs such as wages, salaries, and social security taxes. It, therefore, is of the opinion that past service benefit costs should be charged to operations during the current and future periods benefited, and should not be charged to earned surplus *at the inception of the plan.* The committee believes that, in the case of an *existing plan* under which inadequate charges or no charges for past services have been made thus far and the company has decided to conform its accounting to the preferred procedure

expressed in this bulletin, it may be appropriate to charge to earned surplus the amount that should have been accumulated by charges to income since inception of the plan.

4. In addition to the basic features of a pension plan relating to employee eligibility and the level of pension payments, other factors enter into the determination of the ultimate costs of pensions. Some of these are:

(a) other benefits (such as social security) where amounts of pension payments are integrated therewith;

(b) length of life of employees both before and after retirement;

(c) employee turnover;

(d) in some cases, alternatives as to age at which employees may retire;

(e) future compensation levels; and

(f) in a funded plan, future rates of earnings on the fund and the status of fund investments.

Because of these factors, the total cost of the pensions that will be paid ultimately to the present participants in a plan cannot be determined precisely in advance, but, by the use of actuarial techniques, reasonably accurate estimates can be made. There are other business costs for which it is necessary to make periodic provisions in the accounts based upon assumptions and estimates. The committee believes that the uncertainties relating to the determination of pension costs are not so pronounced as to preclude similar treatment.

5. In the view of many, the accrual of costs under a pension plan should not necessarily be dependent on the funding arrangements provided for in the plan or governed by a strict legal interpretation of the obligations under the plan. They feel that because of the wide-spread adoption of pension plans and their importance as part of compensation structures, a provision for cancellation or the existence of a terminal date for a plan should not be the controlling factor in accounting for pension costs, and that for accounting purposes it is reasonable to assume in most cases that a plan, though modified or renewed (because of terminal dates) from time to time, will continue for an indefinite period. According to this view, costs based on current and future services should be systematically accrued during the expected period of active service of the covered employees, generally upon the basis of actuarial calculations. Such calculations may be made as to each employee, or as to categories of employees (by age, length of service, or rate of pay, for example), or they may be based upon an average of the expected service lives of all covered employees. These calculations, although made primarily for funding purposes, may be used also for accounting purposes. They should, of course, be revised at intervals. Also according to this view, costs based on past services should be charged off over some reasonable period, provided the allocation is made on a systematic and rational basis and does not cause distortion of the operating results in any one year. The length of the period benefited by costs based on past services is subject to considerable difference of opinion. Some think that the benefits accrue principally during the early years of a plan; others feel that the period primarily benefited approximates the remaining service life of the employees covered by a plan at the time of its

adoption; still others believe that the benefits of such costs extend over an indefinite period, possibly the entire life of a plan and its successors, if any. In practice, costs based on past services have in many instances been charged off over a ten- to twelve-year period, or over a fixed longer period such as twenty or thirty years. (The minimum period presently permitted for tax purposes is ten years if the initial past-service cost is immediately paid in full, or about twelve years if one-tenth of the initial past-service cost plus interest is paid each year.)

6. In the view of others, the full accrual of pension costs may be unnecessary. They point out that in some cases accounting for such costs in the manner indicated in paragraph 5 would result, as to a given year or cumulatively or both, in the accrual of costs under a pension plan in amounts differing materially from the payments made under the plan into a pension fund or to retired employees, and in other cases it would require the employer to record pension costs in amounts varying widely from his legal liabilities. They say that a company would in all probability never be called upon to utilize the entire amount of an actuarially calculated full statements for the year in which this tion of the business, any amounts accrued with respect to employees who have not at the time acquired vested rights would, except for a voluntary act of grace, revert to the surplus of the company. They also believe that in the case of an unfunded or partially funded plan the accumulation of a substantial accrual would lead to pressure for full funding, possibly to the detriment of the company and its security holders, and that fear of this might deter management from entering into pension arrangements beneficial to employees. They also feel that the method of accounting envisioned in paragraph 5 disregards the probability that future unfavorable changes in a company's economic position undoubtedly would lead to changes in the pension arrangements it would make for its employees. According to this view, management should have wider discretion in accounting for pension costs, provided there is adequate disclosure as to the method followed.

7. The committee regards the method outlined in paragraph 5 as being the method most likely to effect a reasonable matching of costs and revenues, and therefore considers it to be preferable. However, the committee believes that opinion as to the accounting for pension costs has not yet crystallized sufficiently to make it possible at this time to assure agreement on any one method, and that differences in accounting for pension costs are likely to continue for a time. Accordingly, for the present, the committee believes that, as a minimum, the accounts and financial statements should reflect accruals which equal the present worth, actuarially calculated, of pension commitments to employees to the extent that pension rights have vested in the employees, reduced, in the case of the balance sheet, by any accumulated trusteed funds or annuity contracts purchased.

8. The committee believes that the costs of many pension plans are so material that the fact of adoption of a plan or an important amendment to it constitutes significant information in financial statements. When a plan involving material costs is adopted, there should be a footnote to the financial statements for the year in which this occurs, stating the important features of the plan, the proposed method of funding or paying, the estimated annual

charge to operations, and the basis on which such annual charge is determined. When an existing plan is amended to a material extent, there should be similar disclosure of the pertinent features of the amendment. When there is a change in the accounting procedure which materially affects the results of operations, there should be appropriate indication thereof. If there are costs of material amount based on past or current services for which reasonable provision has not been, or is not being, made in the accounts, appropriate disclosure should be made in a footnote to the financial statements as long as this situation exists.

The statement entitled "Accounting for costs of Pension Plans" was adopted unanimously by the twenty-one members of the committee, of whom six, Messrs. Flatley, Jennings, Lindquist, Luther, Powell and Staub, assented with qualification.

The six members assenting with qualification object to that part of paragraph 3 which appears to sanction the charging to earned surplus in some circumstances of pension costs based on past service. They believe this to be in conflict with section A of chapter 13 of Accounting Research Bulletin No. 43 in which the committee expresses the opinion that costs of annuities based on past service should not be charged to surplus. They consider the conclusions expressed in chapter 13 to be sound for the reasons therein stated.

Qualifications of Accountants

The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the place of his residence or principal office.

The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person, or any affiliate thereof, in whom he has any financial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

In determining whether an accountant is in fact independent with respect to a particular registrant, the Commission will give appropriate consideration to all relevant circumstances including evidence bearing on all relationships between the accountant and that registrant or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.

from REGULATION S-X *(Rule 2-01), The Securities and Exchange Commission, 1955.*

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